



**DESAUTELS**

Capital Management  
Gestion de capitaux

# 2015 ANNUAL REPORT



**McGill**



# DESAUTELS

Capital Management  
Gestion de capitaux



***“An investment in knowledge pays the best interest.”***

**- Benjamin Franklin**



### **Dedication**

***We would like to dedicate this Annual Report to H. Arnold Steinberg, McGill Chancellor Emeritus. Among his many contributions to McGill, Mr. Steinberg was an avid supporter of Desautels Capital Management. He noted last year: “I was truly impressed by the 2014 Annual Report. Among all the various reports I receive throughout the year the Desautels Capital Management reports top the list.” We could not have dreamed of a greater compliment and are honoured to have been entrusted with his confidence.***

# Table of Contents

---

<b>Message from DCM</b>	5
<b>Executive Team</b>	6
<b>Board of Directors</b>	7
<b>Our Team</b>	8
<b>Global Equity Fund</b>	
2015 Performance Summary & Attribution	13
Equity Markets Review and Outlook	19
Risk Management	35
Financials	41
Energy	65
TMT	84
Consumers	104
Industrials	118
Materials	133
Health Care	144
<b>Fixed Income Fund</b>	
2015 Performance Summary & Positioning	160
Fixed Income Markets Review and Outlook	164
Holdings Review	174
<b>Program Alumni</b>	183
<b>Disclaimer</b>	186

## Message from the DCM Executive Team

---

Dear Investors,

We are pleased to report that 2015 was another great year for Desautels Capital Management, both in terms of Fund performance and improvements to the program structure. We continue to attract top students from across the world, and job placements are outstanding, both for Junior Analyst internships and Senior Analyst full time placements. It is our view that the Honours in Investment Management program provides students with the best preparation in the world for a career in the financial sector. Admittedly, we may be slightly biased. This year, however, we did receive some confirming evidence as two of our students, Drew Allen and Phil Rich, took home first place at the Harvard Financial Analyst Symposium stock pitch competition.

The goal of our program is to provide students with the highest level of experiential education not only with regards to investing, valuation, portfolio management, and risk management, but also to provide students with the experience of running an investment management company. To that end we introduced a new student role this year, Chief Operating Officer. Direct reports to the COO include the Accounting Analyst, Information Systems Analyst, and Marketing Analyst. One of the COO's projects this year will be to work with the Marketing Analyst to develop an asset raising marketing plan. Indeed, raising AUM is an integral part of the investment management industry and we plan to get students more involved on that front going forward.

This past year saw some changes to our Board of Directors. Ann-Maureen Hennessy and Elliot Greenstone were instrumental in guiding DCM along the right path, particularly in the areas of compliance and operations, and we are forever grateful for their contributions. Elliot will be replaced on the Board by his colleague Nicolas Morin from Davies Ward Phillips & Vineberg. Joining Nicolas on the Board is Yves Caron, Vice President at Infini-t Wealth Manager Advisers. We look forward to working with Nicolas and Yves and appreciate their already significant contributions.

We would also like to thank Desautels' new Dean and Professor of Finance, Isabelle Bajoux, who has taken an active leadership role at DCM and has become a champion of the program.

Of course, we thank our investors and program sponsors who make this all possible. You have made an incredible impact on the lives of now close to 100 DCM alumni. Our students continue to do their very best to manage your funds with the utmost respect, dedication, and professionalism.

Finally, we are pleased to report that the Desautels Faculty of Management is launching a new Masters of Management in Finance (MMF) program in July 2016. Building on the success of the HIM program, DCM will play a central role in the new Masters program. In addition to 11 courses and a research project, masters students will work as analysts at DCM to manage a third fund. We are very excited to launch this new chapter at DCM. 2016 is certain to be another action packed year.

Sincerely,

Morty Yalovsky, Ken Lester, Vadim di Pietro, Jan Ericsson



## DCM Executive Team

---



---

**MORTY YALOVSKY, PRESIDENT**

---

Professor Morty Yalovsky is the President of Desautels Capital Management. He joined the faculty in 1974, and in addition to his academic responsibilities, he has assumed several senior administrative roles, including Vice-Principal (Administration and Finance) at the University level. Professor Yalovsky's research interests include Statistical Methodology, Forecasting Methods, and Modeling. He has also consulted in the areas of Applied Statistics and Information Technology for several leading Canadian corporations.

---

**KEN LESTER, CO-CHIEF INVESTMENT OFFICER**

---

Ken Lester is the Co-Chief Investment Officer and registered Advising Representative for Desautels Capital Management. Ken has been teaching Applied Investments to BComs and MBAs at McGill since 1992 and currently also teaches Behavioural Finance. Ken has over 20 years of experience in the investment management industry and is President and CEO of Lester Asset Management.



---

**VADIM DI PIETRO, CO-CHIEF INVESTMENT OFFICER**

---

Vadim di Pietro is Co-Chief Investment Officer, Chief Compliance Officer, and registered Advising Representative for Desautels Capital Management. He joined the Faculty of Management as a Faculty Lecturer in Finance in 2009. Prior to Desautels, Vadim was an investment strategist at J.P. Morgan in London from 2007 to 2009. He holds a B.Eng. from McGill University, a Master's in Mathematical Finance from the University of Toronto, and a PhD in Finance from the Kellogg School of Management. Vadim is also a CFA charterholder.



---

**JAN ERICSSON, HIM PROGRAM DIRECTOR**

---

Professor Ericsson joined the Desautels Faculty of Management in 1999 with a PhD from the Stockholm School of Economics. Professor Ericsson's current research focuses on risk premia in corporate bond and credit derivative markets, and has been published in, among others, the Journal of Business and the Journal of Finance. He is a frequent guest speaker at industry conferences and has carried out consulting projects for a Nordic real estate investment firm, the Swedish National Debt Office, as well as for a hedge fund startup in Scandinavia.



## DCM Board of Directors

---



---

### YVES CARON, DIRECTOR

---

*Vice President, iNFini-t Wealth Management Advisers Inc.*

Prior to his current role advising high net worth clients and foundations with respect to their portfolios, Yves spent 10 years managing alternative investment portfolios for institutional investors globally at HR Strategies Inc.

---

### PETER BETHLENFALVY, DIRECTOR

---

*Chief Investment Officer, C.S.T. Consultants Inc*

Mr. Peter Bethlenfalvy is Chief Investment Officer at Canadian Scholarship Trust (CST) where he is responsible for the investment strategy and management of the \$4 Billion CST investment portfolio, including aspects of risk, regulations and oversight. Prior to joining CST, Mr. Bethlenfalvy was Senior Vice President, Financial Regulations at Manulife Financial Corporation



---

### EAMONN MCCONNELL, DIRECTOR

---

*Portfolio Manager, Kensington Capital*

Mr. McConnell is a member of the Kensington Investment Committee and is the Kensington advising representative. Mr. McConnell is also an equity partner of Gryphus Capital, a Private Equity firm he co-founded in 2002 based in Singapore and was the Deputy Chairman of the Alternative Investment Management Association (AIMA) Canada from 2008 to 2013.



---

### NICOLAS MORIN, DIRECTOR

---

*Partner, Davies Ward Phillips &Vineberg*

Mr. Morin is a partner at Davies Ward Phillips & Vineberg LLP in the Capital Markets, Mergers & Acquisitions, and Corporate/Commercial practices.



---

### RICHARD PAN, DIRECTOR

---

*VP and Head of Corporate Finance, Power Corporation*

Mr. Pan is currently Vice-President and Head of Corporate Finance and is responsible for strategic and corporate planning at Power Corporation and at Power Financial. Before joining Power Corporation in 2008, Mr. Pan was an Executive Director in Investment Banking with Goldman Sachs International based in London, England.



# OUR TEAM

---

## FUND MANAGERS



---

DREW ALLEN

*Global Equity Strategist*

2016 Full Time

Analyst, Investment Banking

BMO Capital Markets,  
Toronto



---

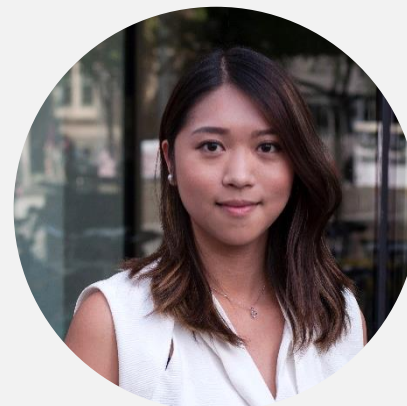
PETER HUO

*Fixed Income Strategist*

2016 Full Time

Analyst, Investment Banking

Bank of America Merrill Lynch,  
Montreal



---

CHRISTIE WEI

*Risk Manager*

2016 Full Time

Analyst, Equity Research

J.P. Morgan & Co.,  
New York

## SENIOR ANALYSTS



---

NAOMIE GENDRON

*Analyst, Health Care*

2016 Full Time

Analyst, Investment Banking

Credit Suisse,  
Toronto



---

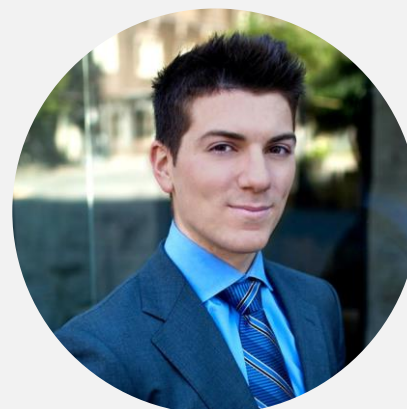
CHRISTOPHE LUSSIER

*Analyst, Energy*

2016 Summer Internship

Analyst, Corporate Finance

KPMG,  
Montreal



---

JORDAN OWEN

*Analyst, Industrials*

2016 Full Time

Junior Broker, Real Estate

Colliers,  
Montreal



# OUR TEAM

---

## SENIOR ANALYSTS



---

PHILIPPE RICH

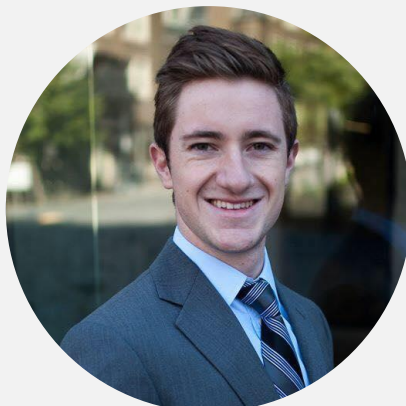
---

***Analyst, Financials***

2016 Full Time

Analyst, Investment Banking

Morgan Stanley,  
Toronto



---

HENRI ST-PIERRE

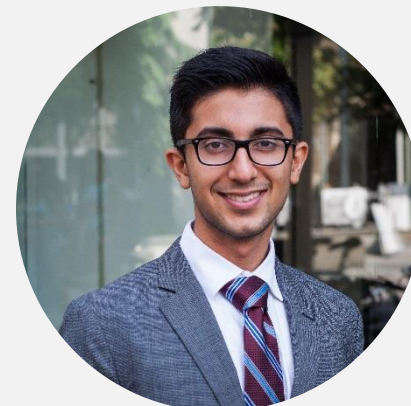
---

***Analyst, TMT***

2016 Full Time

Associate, Consulting

Boston Consulting Group,  
Montreal



---

SEAN SAGGI

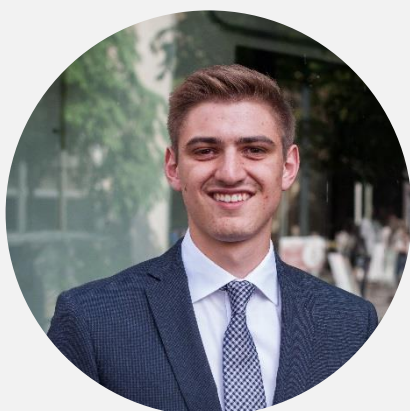
---

***Analyst, Financials***

2016 Full Time

Analyst, Investment Banking

RBC Capital Markets,  
Toronto



---

ALEX VERRONEAU

---

***Analyst, Materials***

2016 Summer Internship

Analyst, Investment Banking

J.P. Morgan & Co.,  
New York



---

LUOHAN WEI

---

***Analyst, TMT***

2016 Full Time

Associate, Consulting

Bain & Co.,  
San Francisco

# OUR TEAM

---

## JUNIOR ANALYSTS



---

OLIVIER BABIN

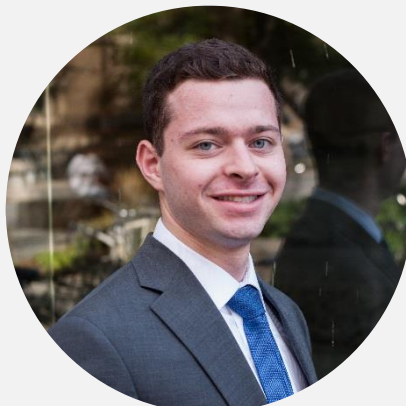
---

***Analyst, Financials***

2016 Summer Internship

Analyst, Investment Banking

Goldman Sachs & Co.,  
New York



---

NEIL CORBER

---

***Analyst, Financials***

2016 Summer Internship

Analyst, Investment Banking

BMO Capital Markets,  
Toronto



---

ANDRE COTE-BARCH

---

***Analyst, Industrials***

2016 Summer Internship

Analyst, Private Equity

PSP Investments,  
Montreal



---

SERCAN DEMIRTAS

---

***Analyst, Materials***

2016 Summer Internship

Analyst, Private Equity

Goldman Sachs & Co.,  
London



---

MICHAEL FISHMAN

---

***Analyst, Fixed Income***

2016 Summer Internship

Associate, Consulting

Boston Consulting Group,  
Toronto



---

KENDYL FLINN

---

***Analyst, Energy***

2016 Summer Internship

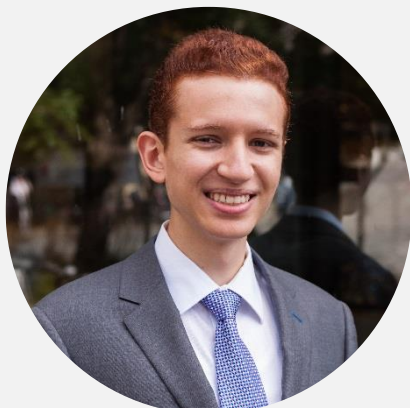
Analyst, Investment Banking

J.P. Morgan & Co.,  
San Francisco

# OUR TEAM

---

## JUNIOR ANALYSTS



---

**JONATHAN KAMEL**

*Analyst, Fixed Income*

2016 Summer Internship

Analyst, Private Investments

CPPIB,  
Toronto



---

**LAMBERT LEFEBVRE**

*Analyst, Consumers*

2016 Summer Internship

Analyst, Private Equity

Ulysses Management,  
New York



---

**DAVID MARCOVITCH**

*Analyst, TMT*

2016 Summer Internship

Analyst, Investment Banking

Credit Suisse,  
Toronto



---

**ADAM MARCOVITZ**

*Analyst, Fixed Income*

2016 Summer Internship

Analyst, Investment Banking

BMO Capital Markets,  
Toronto



---

**MEAGAN PRINS**

*Analyst, Health Care*

2016 Summer Internship

Analyst, Investment Banking

Goldman Sachs & Co.,  
New York



---

**TONY REN**

*Analyst, TMT*

2016 Summer Internship

Analyst, Investment Banking

PJT Partners,  
New York



## OUR TEAM

---

### JUNIOR ANALYSTS



---

**MICHAEL SASKIN**

---

*Analyst, Consumers*

2016 Summer Internship

Analyst, Private Equity

Onex,  
Toronto



---

**ANISH SHAH**

---

*Analyst, Fixed Income*

2016 Summer Internship

Analyst, Investment Banking

RBC Capital Markets,  
Toronto



---

**JAMIE WILSON**

---

*Analyst, Energy*

2016 Summer Internship

Analyst, Investment Banking

Goldman Sachs & Co.,  
London

### ECONOMICS



---

**ARCHER SHEN**

---

*Economic Analyst*

2015 Summer Internship

Analyst, Investment Banking

GF Securities,  
Shanghai

# Desautels Global Equity Fund

2015 Performance Summary & Attribution

*By Drew Allen, Global Equity Strategist*





## Global Equity Fund: 2015 Performance Summary & Attribution

Dear Investor,

We are pleased to report that the Desautels Global Equity Fund returned 5.9% gross of fees in 2015, compared to our benchmark return of 2.6% (60% S&P TSX, 40% S&P 500 in CAD). On a risk adjusted basis, the fund generated a Sharpe ratio of 0.24, versus 0.01 for the benchmark. The fund's outperformance this year has helped to strengthen our long-term track record. Since inception, we are outperforming the benchmark by an annualized 1.6%. On a risk adjusted basis, we have generated 3.2% of annual alpha since inception.

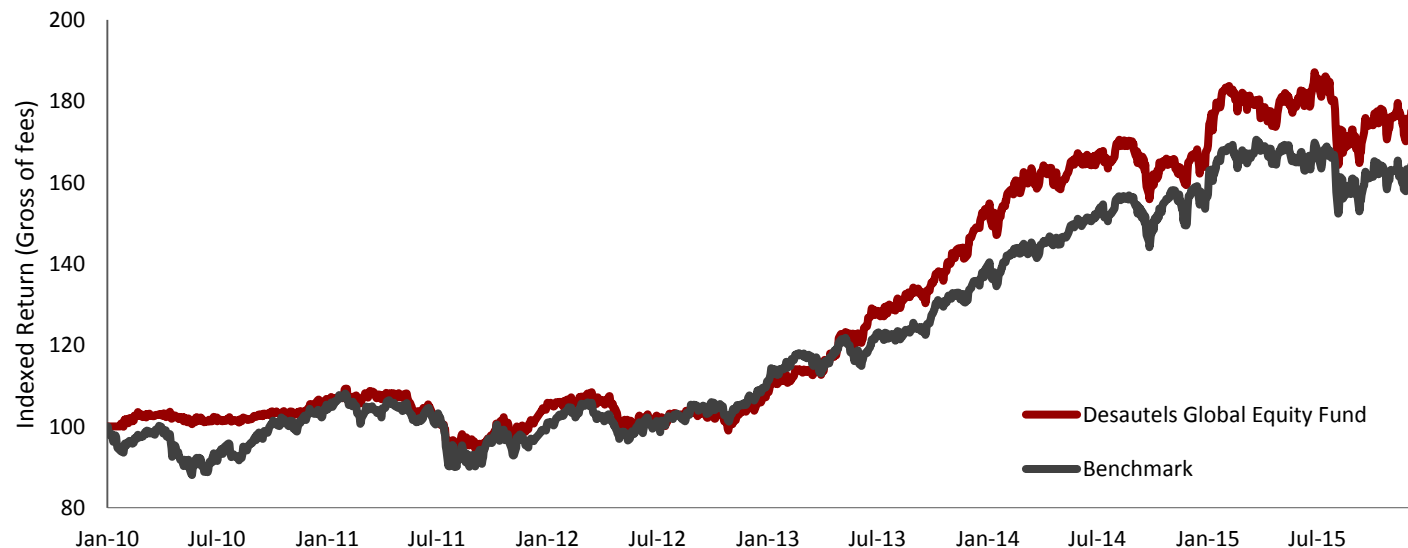
Looking at the performance of sectors within the Equity Fund, our Materials and Health Care sectors were the best relative performers, beating their respective benchmarks by 26.1% and 24.7%. Our outperformance in Materials was driven by our near 0% allocation for the majority of the year towards the Metals & Mining subsector, which was one of the S&P 500's poorest performing subsectors in 2015, posting a total return of -38.9%. For Health Care, we benefited greatly from the strong performance in our two largest holdings in the sector, Vascular Solutions Inc. and Celgene Corp. Health Care was also our best absolute performer, returning 48.6% in the year. Our Technology & Media sector was the key laggard, underperforming its respective benchmark by 35.1%.

Global Equity Fund Returns			
Time Period	Gross Return	Net Return	Benchmark
2015	5.9%	4.5%	2.6%
Q1 2015	8.3%	7.9%	5.6%
Q2 2015	0.3%	(0.1%)	(2.1%)
Q3 2015	(6.6%)	(7.0%)	(3.9%)
Q4 2015	4.4%	4.1%	3.3%
2 year*	8.7%	7.2%	9.1%
Since Inception*	10.0%	8.4%	8.4%

\*Returns are annualized.

Performance Metrics				
	Equity Fund		Benchmark	
	2015	Inception	2015	Inception
Annualized Return	5.9%	10.0%	2.6%	8.4%
Annualized Std Dev	14.6%	11.1%	13.7%	12.1%
Annualized Sharpe Ratio	0.24	0.68	0.01	0.49
Beta	0.97	0.73		
Annualized Alpha	3.4%	3.2%		
Daily Tracking Error	0.4%	0.5%		

Performance metrics are calculated gross of fees.



Note: Performance is as of Dec. 31, 2015, gross of fees. Benchmark is the MSCI World Index from inception to February 28, 2013 and a 60% S&P TSX, 40% S&P 500 (measured in CAD) blended benchmark thereafter. Fund inception date is January 20, 2010.

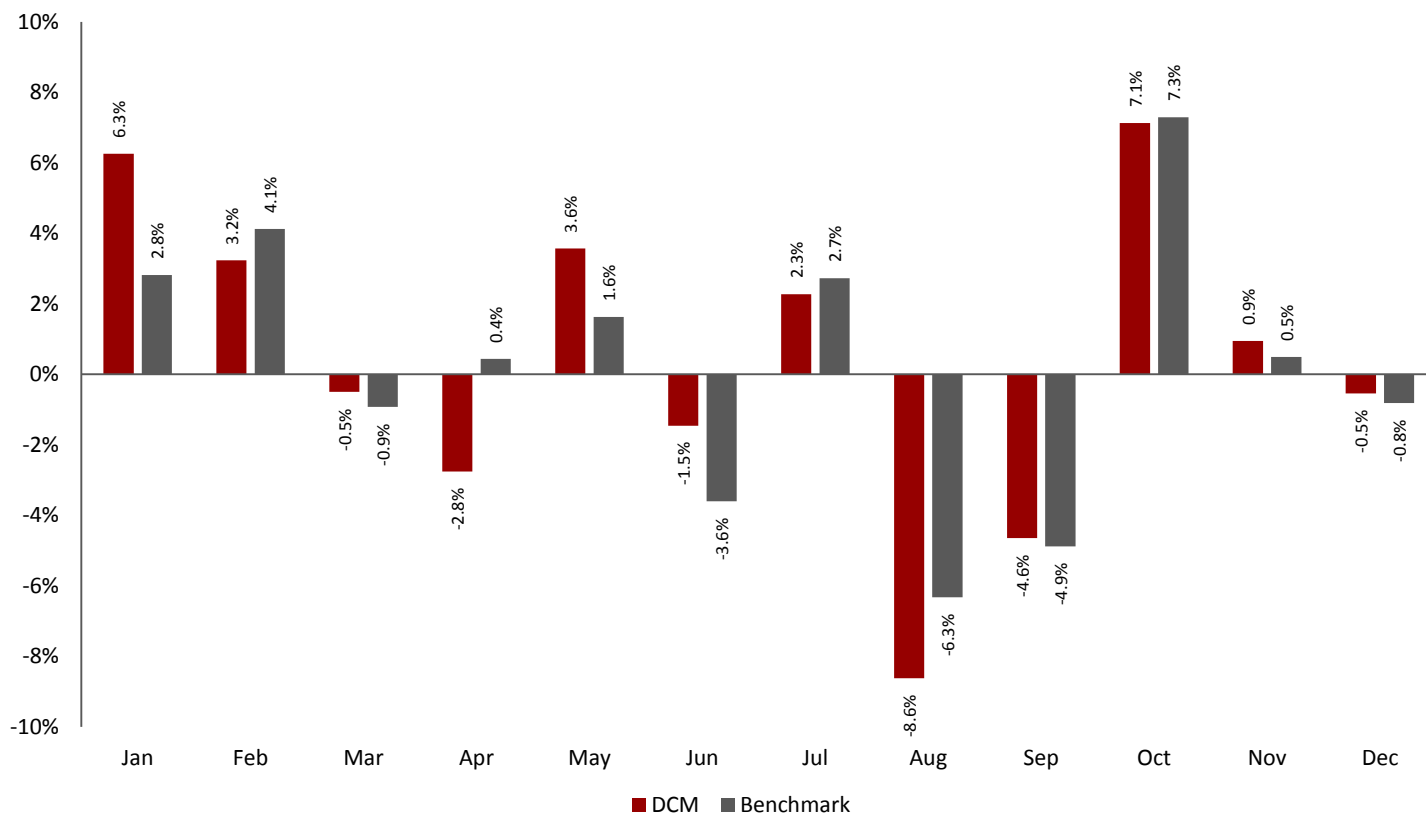
## Global Equity Fund: 2015 Performance Summary & Attribution

Figure 1: Global Equity Fund 2015 Sector Returns vs. Sector Benchmarks

Sector Returns			
	Sector Return	Benchmark	+/-
Materials	-5%	-31%	26%
Healthcare	49%	24%	25%
Financials	19%	2%	17%
Telecom	7%	2%	5%
Energy & Utilities	-20%	-20%	0%
Consumer Staples	7%	15%	-8%
Industrials	2%	15%	-13%
Consumer Discretionary	2%	24%	-22%
Technology & Media	-13%	22%	-35%

Note: Details for sector benchmarks can be found in the individual sector reports.

Figure 2: Global Equity Fund Monthly Returns vs. Benchmark



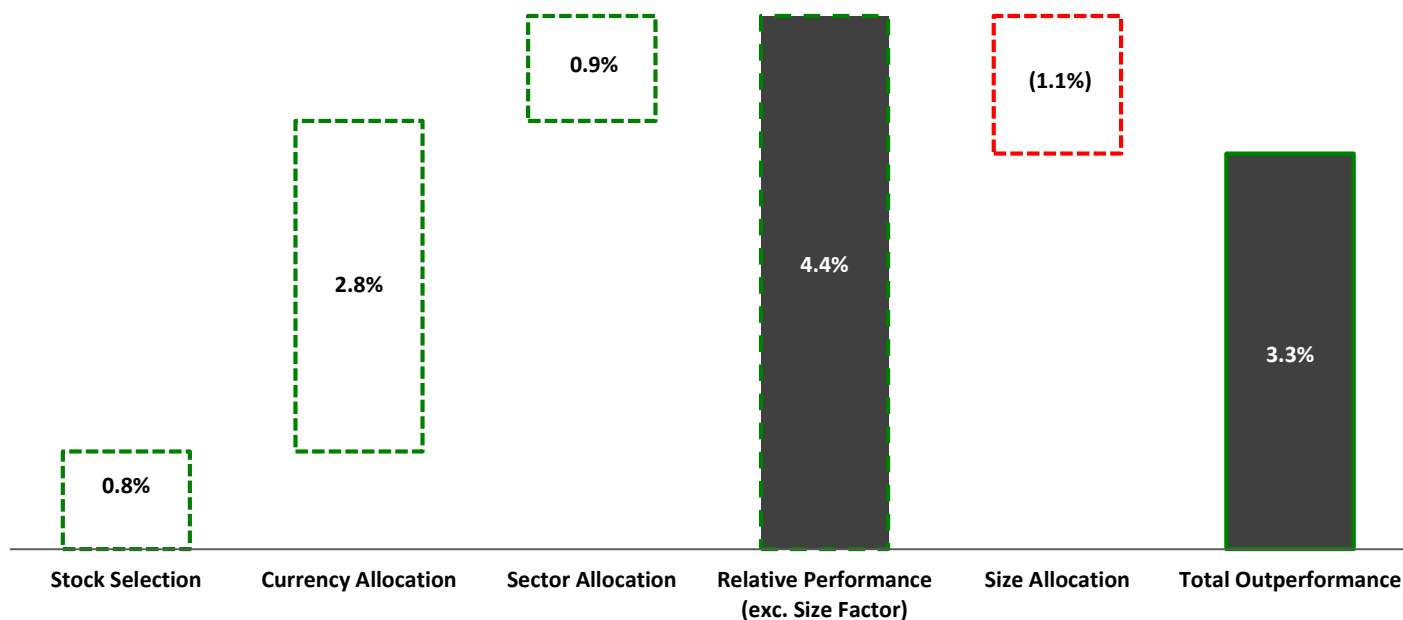
## Global Equity Fund: 2015 Performance Summary & Attribution

Figure 3 shows the key drivers of our relative performance in 2015. Stock selection, currency allocation, and sector allocation all played an active role in our outperformance. For currency, we made an active decision at the start of the year to overweight USD exposure due to our bullish view on the US economy relative to Canada. We began the year approximately 20% overweight the USD, which paid off as the greenback returned 7.8% in H1. In the second half of the year, we began to unwind our overweight position in the USD, and move closer towards a 50%/50% allocation in both currencies, for both risk management purposes as well as our perceived further limited upside in the USD. Overall, currency allocation contributed 2.8% to our relative outperformance in 2015.

Stock selection was another factor that contributed to our outperformance. Our fund benefitted greatly from positions in Lundin Mining, Vascular Solutions, and New York REIT. The largest contributor, however, was Amazon.com, which we initiated in November of 2014. Our original thesis was centred around the company's rapidly expanding e-commerce business, as well as Amazon's long term cost structure being far more attractive than the world's largest existing retailers. Our thesis materialized over the course of 8 months and 3 substantial earnings beats, which left us with a holding period return of more than 80%.

The one detractor from our relative outperformance was size allocation. Both the Russell 2000 and TSX Small Cap indices underperformed the broader benchmarks in 2015, detracting 1.1% from our relative performance. Our exposure to small caps is an active decision, as we believe that in the current state of elevated valuations in the market, small caps provide a greater opportunity of identifying market inefficiencies.

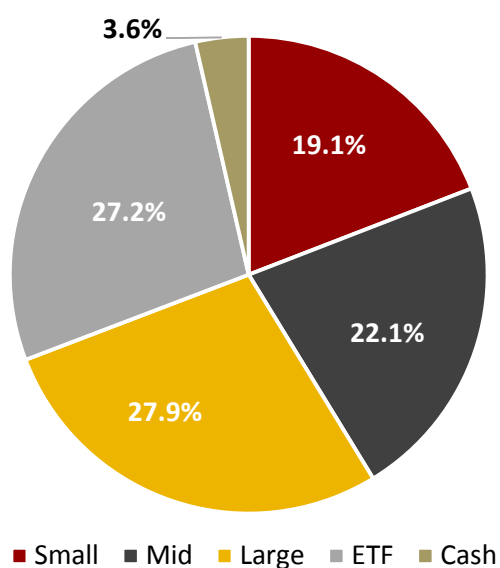
**Figure 3: DCM 2015 Relative Performance Attribution**



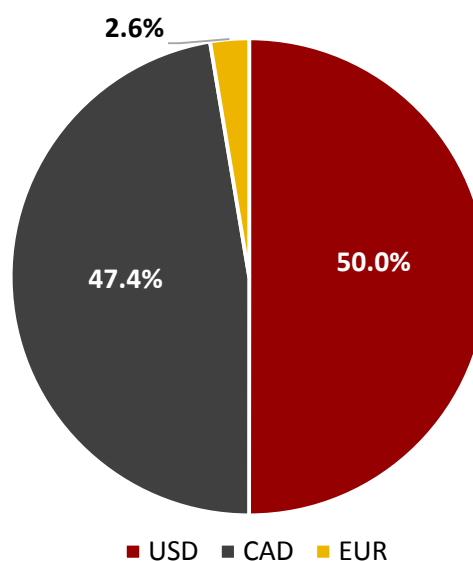
## Global Equity Fund: Portfolio Positioning

Global Equity Fund - Current Sector Allocation			
Sector	Global Equity Fund	Benchmark	(+/-)
Financials	33.0%	29.6%	3.4%
USD	2.5%	0.0%	2.5%
Health Care	9.3%	8.0%	1.3%
Materials	8.0%	6.8%	1.2%
CAD	1.1%	0.0%	1.1%
Consumer Discretionary	9.7%	9.3%	0.4%
Utilities	2.3%	2.5%	(0.1%)
Telecommunication Services	3.7%	4.2%	(0.5%)
Industrials	7.5%	9.0%	(1.5%)
Energy	12.1%	13.7%	(1.6%)
Information Technology	8.1%	10.2%	(2.1%)
Consumer Staples	2.6%	6.7%	(4.1%)
<b>Total</b>	<b>100.0%</b>	<b>100.0%</b>	<b>0.0%</b>

**Figure 4: Size Exposure**



**Figure 5: Currency Exposure**



Note: 27.2% allocation towards ETF due to large cash position which was generated in the summer months when we exited certain positions at a time when there were no new ideas coming into the fund. Instead of holding cash, we initiated positions in certain ETF's to reduce our tracking error. All values as of Dec 31, 2015

# Global Equity Fund: Holdings List

**Figure 6: Global Equity Fund Holdings List**

Global Equity Fund - Holdings List									
#	Security Name	Sector	Currency Exposure	Size	# of Units	Local Cost / Unit	Local Price / Unit	Base Market Value	Position Size %
1	iShares S&P/TSX 60 Index ETF	ETF	CAD	ETF	17,657	\$21.13	\$19.22	\$339,368	11.9%
2	iShares S&P/TSX Capped Financials	Financials	CAD	ETF	8,345	30.28	29.58	246,845	8.7%
3	Wells Fargo	Financials	USD	Large	2,011	32.68	54.36	151,854	5.3%
4	New York Reit Inc.	Financials	USD	Mid	9,300	11.06	11.50	148,564	5.2%
5	Industrial Alliance Insurance	Financials	CAD	Mid	2,912	40.01	44.13	128,507	4.5%
6	Time Warner Inc.	Information Technology	USD	Large	1,350	81.07	64.67	121,275	4.3%
7	Westrock	Materials	USD	Mid	1,817	55.08	45.62	115,145	4.0%
8	Intel	Information Technology	USD	Large	2,065	25.32	34.45	98,820	3.5%
9	Vascular Solutions	Health Care	USD	Small	1,950	28.11	34.39	93,154	3.3%
10	Pulse Seismic	Energy	CAD	Small	40,973	2.89	2.22	90,960	3.2%
11	Cogent Communications	Telecommunication Services	USD	Mid	1,830	33.61	34.69	88,184	3.1%
12	Parex Resources	Energy	CAD	Mid	8,060	7.30	10.16	81,890	2.9%
13	Western Forest Products	Materials	CAD	Small	36,191	1.98	2.26	81,792	2.9%
14	General Motors	Industrials	USD	Large	1,640	32.01	34.01	77,479	2.7%
15	Intesa SanPaolo Spon ADR	Financials	EUR	Large	2,705	19.23	19.99	75,094	2.6%
16	US Dollar	USD	USD	Cash	51,603	1.00	1.00	71,682	2.5%
17	iShares S&P Global Consumer Disc. ETF	Consumer Discretionary	CAD	ETF	2,460	29.52	28.77	70,774	2.5%
18	Union Pacific	Industrials	USD	Large	635	76.65	78.20	68,979	2.4%
19	TJX Companies	Consumer Discretionary	USD	Large	700	62.98	70.91	68,951	2.4%
20	Marathon Petroleum	Energy	USD	Large	940	44.14	51.84	67,690	2.4%
21	Celgene	Health Care	USD	Large	400	108.85	119.76	66,543	2.3%
22	CRH Medical	Health Care	CAD	Small	16,200	3.87	4.10	66,420	2.3%
23	Ten Peaks Coffee	Consumer Discretionary	CAD	Small	5,540	11.07	11.90	65,926	2.3%
24	West End Indiana Bancshares	Financials	USD	Small	1,900	22.22	23.15	61,100	2.1%
25	iShares Global Consumer Staples ETF	Consumer Staples	USD	ETF	460	87.21	93.24	59,579	2.1%
26	BMO Equal Weight Util. Index	Utilities	CAD	ETF	4,065	15.76	14.60	59,349	2.1%
27	Performance Sports Group	Consumer Discretionary	CAD	Small	3,485	12.96	13.34	46,490	1.6%
28	MEG Energy	Energy	CAD	Mid	5,195	33.15	8.02	41,664	1.5%
29	Pangaea Logistics Solutions	Industrials	USD	Small	10,749	5.38	2.66	39,718	1.4%
30	Canadian Dollar	CAD	CAD	Cash	30,959	1.00	1.00	30,959	1.1%
31	Lannett Co.	Health Care	USD	Mid	500	61.17	40.12	27,865	1.0%
<b>Total</b>								<b>\$2,852,617</b>	<b>100.0%</b>

Note: All values are as of Dec. 31, 2015.



# Desautels Global Equity Fund

Equity Markets Review and Outlook

*By Drew Allen, Global Equity Strategist*



## 2015 Review and Market Commentary

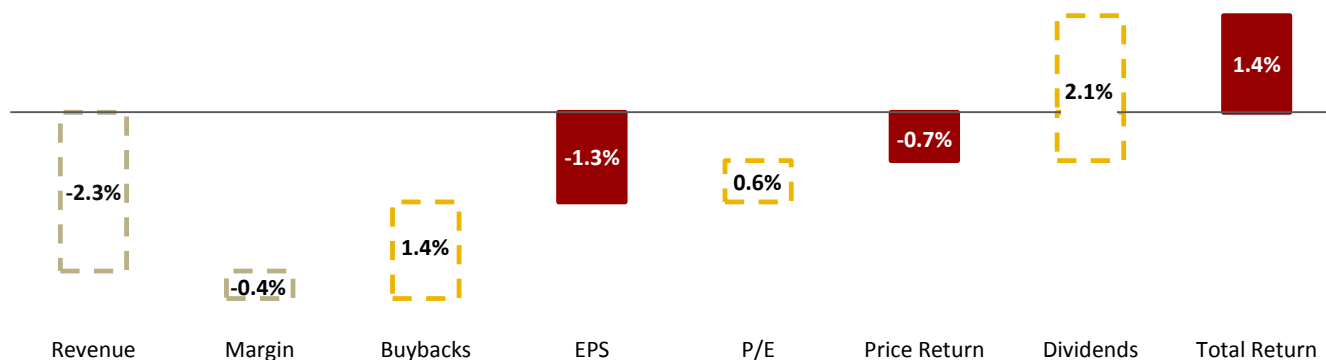
One thousand, four hundred and twelve. That’s the number of days that the S&P 500 went without experiencing a 10% correction since the start of this bull market back in 2011. Finally, in August 2015, over fears that the collapsing Chinese stock market would lead to slowing global economic growth, the S&P 500 experienced a major correction of over 11%, which wiped out all of its gains for the year and then some. The index closed out 2015 returning a mere 1.4%. North of the border was no exception, as the TSX, which was, up until the summer, relatively flat for the year, fell over 8.4% in August’s rout, and closed out the year down 8.3%. Much akin to 2014, the TSX’s underperformance was attributable almost entirely to sector weightings, as the continued downturn in global oil prices weighed much more heavily on the Canadian benchmark vs. its American counterpart. Applying S&P 500 sector weighting to the TSX would result in a loss of only 2.2%.

Heading into 2015, our fund was bullish on a slow but steady US recovery, given the plateauing of the deleveraging cycle in the US, which we felt, when coupled with rising consumer confidence, would lead to a period of stronger than average economic growth. This led us to take an overweight position in the USD, as we began the year approximately 20% overweight the greenback relative to our benchmark. We have since trimmed allocation, and currently stand around 50% allocation towards both currencies.

### S&P 500 Performance Attribution

Figure 7 decomposes the 2015 S&P 500 return into EPS growth, multiple expansion, and dividends. For the first time since 2011 there was a decline in earnings (-1.3%), driven mainly by a decline in revenue. Return of capital to shareholders was the primary driver of the S&P 500’s yearly return, with buybacks and dividends totaling 3.5%. This so called “earnings recession” in the S&P 500 dominated headlines in the closing months of 2015, as many pointed to earnings growth as a sign that we may be headed for an economic recession. While these claims are not unfounded, given the historical 72% positive correlation between S&P500 earnings growth and US GDP growth, it is important to take into account the effect that the drop in energy prices has had on the index.

**Figure 7: S&P 500 2015 Return Decomposition**

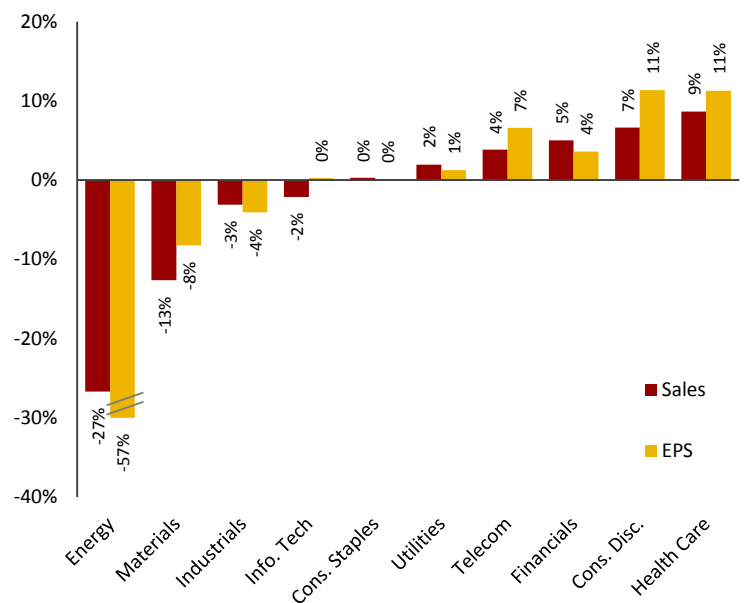


As of Dec. 31, 2015. Note: EPS growth and its components are change in next twelve months expectations.  
Source: Bloomberg, FactSet

## 2015 Review and Market Commentary

Figure 8 breaks down revenue and earnings growth by each sector in the S&P 500. By excluding the 26.7% decrease that the energy sector experienced this past year, the revenue growth of the S&P 500 would clock in at approximately 2.2%, in line with its 2014 growth rate. Similarly, Total Return excl. Energy comes in at approximately 4.2%, suggesting the recent rout in oil prices more than halved the market return in 2015. For this reason, we do not place as much concern on the recent decline in the S&P 500's earnings, as the drag from the commodities sectors is having extremely adverse effects on the index.

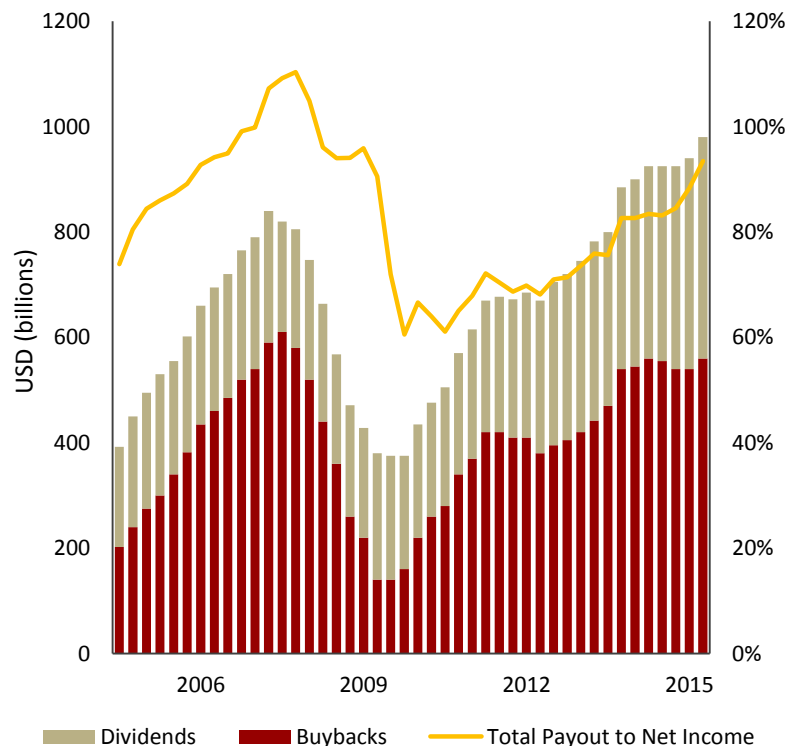
**Figure 8: S&P 500 Revenue & EPS Growth by Sector**



As we look ahead to 2016, we foresee a number of opposing forces that will weigh on the market's EPS growth. Even a slight rally in global oil prices should have a positive effect on top line growth in the energy sector, which we believe will be boosted further by strong performance from the technology and consumer disc. sector. On the other hand, a strong US Dollar will put pressure on many company's top line, potentially eroding per-share earnings growth through transactional effects.

As we noted on the previous page, capital return to shareholders was the main driver of total return in 2015 for the S&P 500, and as Figure 9 shows, dividends and buybacks, as a % of net income, are climbing towards 100%, a level not seen since 2008. In recent years, companies have made use of near-zero interest rate policy to borrow money and return it to shareholders, either through buybacks or a dividend. With the normalization process underway, companies will be hard pressed to continue the same growth rate of shareholder returns, which will subsequently affect EPS and total return of the index itself.

**Figure 9: S&P 500 TTM Capital Returns to Shareholders**

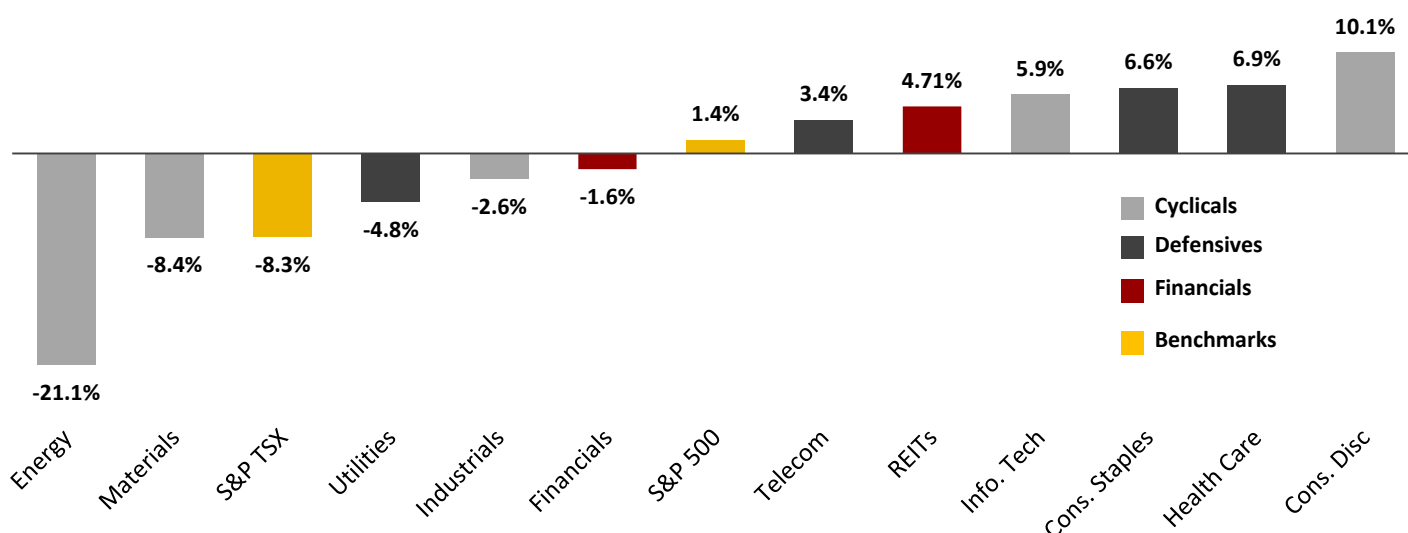


Source: Bloomberg, FactSet

### Sector Performance & Breadth of Return: The Rise of the *One-Percent*

Unlike 2014, when defensive sectors clearly outperformed their cyclical counterparts, 2015 was a much more mixed story. The Consumer Discretionary sector, led by Netflix and Amazon, was the index's only positive double-digit return for the year, while commodity sensitive sectors underperformed across the board (Figure 10). Despite large concerns over pricing in the biotech industry, which led to a 28% sell-off in the sub-sector in the summer months, the Health Care sector as a whole was the market's second best performer, returning 6.9% for the year, and outperforming the broader index for the 5<sup>th</sup> straight year.

**Figure 10: 2015 Sector Total Returns**



In 2014, we wrote about the relative underperformance of small cap stocks to their large-cap peers, citing the underperformance of all 10 sectors in the S&P Small Cap 600 to their peers in the S&P 500. In 2015, it seems that the lack of love for small caps has begun to spread into the mid-cap space. 2015 saw a large increase in the dispersion amongst S&P 500 returns, implying that stock gains were not shared evenly amongst companies. This year more than ever, the benchmark return was boosted disproportionately by a handful of successful large cap stocks. The double- and triple- digit returns of Amazon, Alphabet, Microsoft, Facebook, General Electric, and Netflix helped mask overall poor performance of the S&P 500. If you were to exclude these 6 names, along with 2 other big-cap gainers, the S&P 500 would have been down more than 4%. Should a couple of these large-caps falter in 2016, a positive return on the S&P may be more difficult to achieve. Figure 11 on the following page displays the relative performance of the Russell Top 50, a measure of performance of the largest 50 companies in the Russell 3000, to the performance of the Russell 2000, a good proxy for the performance of small cap stocks.

*Note: All performance data is for S&P 500 Sectors, S&P 500, and S&P/TSX. Total return calculated assuming dividends are reinvested in the index. Source: Bloomberg, CapitalIQ*

**Figure 11: Russell Top 50 vs. Russell 2000**



What makes the fact that mega caps are carrying the weight of total S&P 500 returns is that in 2015 we saw a major reversal in the trend of mega vs. small cap stock performance. For the majority of this bull market which began back in 2009, small cap stocks emphatically outperformed their mega cap peers. As Figure 11 demonstrates the point we made on the previous page, mega caps dramatically outperformed small caps in 2015. While historical data is limited for this type of analysis, due to the history of Russell Top 50 data, we can see that the last time there was a spike in this ratio was during the last turnover of the stock market in 2008.

It is interesting to note that even when excluding the Energy sector from the dispersion analysis, the average S&P 500 stock still had a lackluster year in 2015. All sectors included, the average S&P 500 holding returned -3.6%, versus -1.6% when you exclude energy from the equation. All this goes to suggest that the dispersion issue plaguing the markets is not limited to one sector, but is being felt by the index as a whole.

Source: Bloomberg, CapitalIQ



### Sentiment Outweighing Fundamentals

At the onset of 2015, most people would not have raised an eyebrow if you said that you expected the Fed to hike interest rates sometime between June and September of the upcoming year. With 65% of market participants pricing in a hike by July, it seemed like 2015 would finally bring an end to the period of record-low interest rates. By June, however, with contagion spreading from Europe over a renewed Greek debt crisis, the market expectations for a June hike were a mere 6%, and had pushed back to September as a likely date for the normalization process to begin. But as August rolled around, and the Chinese stock market sell-off spread to global markets, it became clear that the Fed would once again take a pass in September. While we may have finally gotten the long-awaited liftoff in December, if there is one thing that became clear this past year, it is that aesthetics, and not fundamentals, were driving Fed thinking, leading Janet Yellen and the FOMC to wait for the perfect backdrop to begin the hiking process.

The equity markets also displayed very similar thinking to the Fed during 2015. If you were to look solely at the economic backdrop in the US, with core inflation hovering just below 2%, the unemployment rate at 5%, the economy growing at approximately 2.5%, with an output gap still of 3%, you would probably think that the markets were halfway through a bull cycle. Even further, if we take energy out of the picture, the fundamentals of the S&P 500 are still largely intact. Forward Sales and EPS growth for the index excl. energy were up 2.2% and 3.6%, respectively.

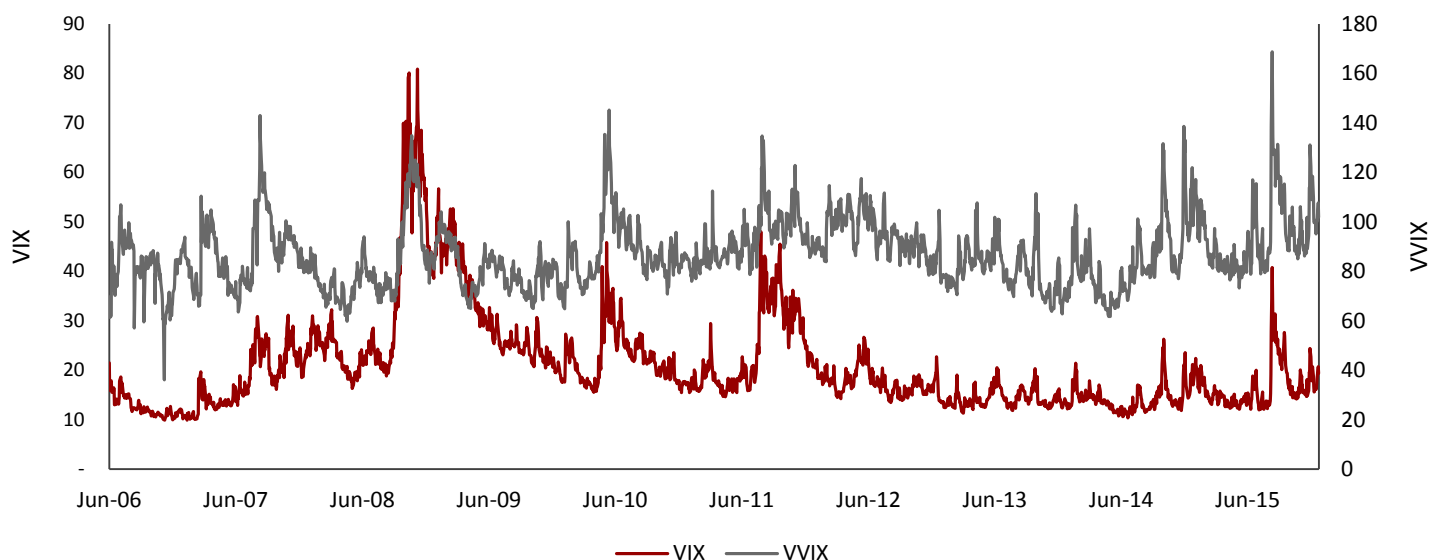
Despite this robust backdrop, 2015 witnessed a considerable deterioration in overall investor sentiment. It is well known that the CBOE VIX Index spiked in August to its highest level since 2011, but something that is less talked about is the surge in the VIX of VIX, otherwise known as the VVIX. The VVIX essentially measures the volatility of volatility itself. It is informative about the expected volatilities that drive the prices of VIX options. In August, the VVIX index spiked to its highest level on record (Figure 12), exceeding past highs seen during the American and European financial crises.

The key insight that the VVIX provides us is the degree of confidence that the market has in its forecast of future values of the VIX. Similarly, the VVIX is an indicator on the level of the uncertainty of uncertainty in the market. In 2015, it would appear as though, despite a strong domestic economy, risks from overseas shot unprecedented amounts of uncertainty through the market.

---

*Source: Bloomberg, US Bureau of Labor Statistics, St Louis Federal Reserve.*

**Figure 12: Historical VIX & VVIX**



### **2015: The Result Was Expected, The Journey Was Not**

A year ago, we discussed in this report the likelihood of the Fed beginning the tightening cycle, the limited upside remaining in S&P 500 valuations, as well as the likelihood of a long period of low returns. As we look back on the year that was, the end result seems to largely be in line with what we expected: Liftoff from the Fed, a mere 0.6% increase in the S&P 500 P/E multiple, and the first negative price return on the market in 5 years. While all of these outcomes may have been what we foresaw, the means by which they came about were anything but expected.

Given the turmoil of the latter half of 2015, it is almost hard to believe that the S&P 500 managed to finish roughly flat. Given the end result, and everything that happened in between, it's as if the stock market was running to nowhere. A 38% drop in the price of oil, on the heels of a 40% drop the year before; a revitalized Greek debt crisis; and the largest Chinese stock-market sell off in history. Taken together, 2015 was far more eventful than the end result might suggest. It leaves behind a blank slate for investors to compose their predictions upon for the upcoming year.

As a bottom-up fund, we rely on macroeconomic analysis from a risk management, as well as positioning, perspective. While the conviction in our individual ideas is the main driver of our allocation, we are mindful of the overall environment in which we are investing. Our primary focus remains bottom-up analysis to identify companies that trade at substantial discounts to their intrinsic value. Our aim is to use this approach to generate superior risk adjusted returns over the long run.

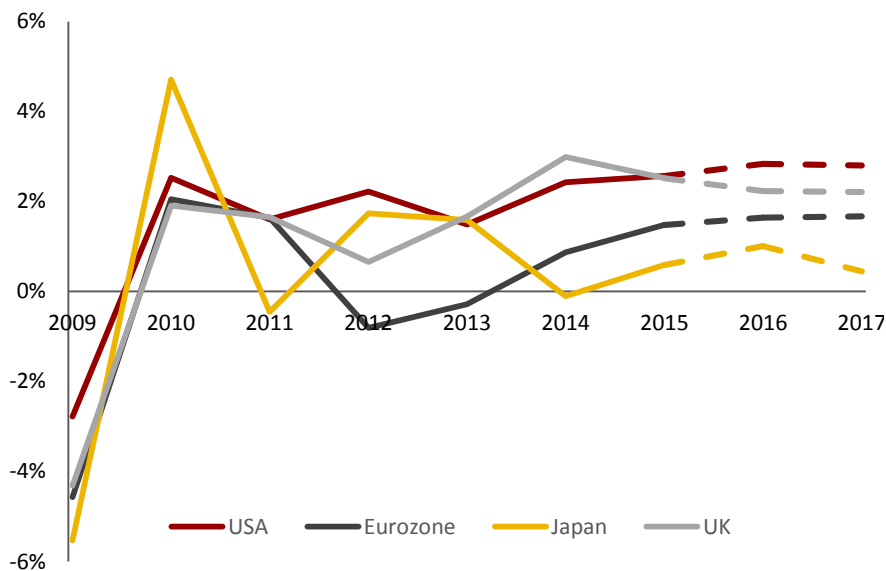
Source: Bloomberg, CapitalIQ, FactSet

## Key Macro Themes

### Theme I – The Great Rebalancing

An important by product of the major themes of 2015 – diverging global monetary policies, a surging US dollar, and a continued fall in oil prices – has been a rebalancing of growth from the US to other parts of the world. Figure 13 illustrates how starting in 2015, and expected to continue into 2016, the real GDPs of the largest developed nations in the world are beginning to converge. The difference in GDP between the US, Eurozone, UK, and Japan is much smaller than in 2014 and prior years, when the world was much more unbalanced. Based on these forecasts, it appears that we may be on the cusp of achieving a much more balanced global economy.

**Figure 13: Real GDP Growth of Developed Nations**



This is important, as a more robust global economy should lead to a more sustainable and durable recovery in the US – one that we believe can last for several more years. Further, stronger economic growth should take off some of the steam that has been propelling the USD to all-time highs. This would be a boon for the US stock market in 2016, as many companies that felt top line pressure as a result of weaker international sales see some of that pressure relieved from stronger global currencies.

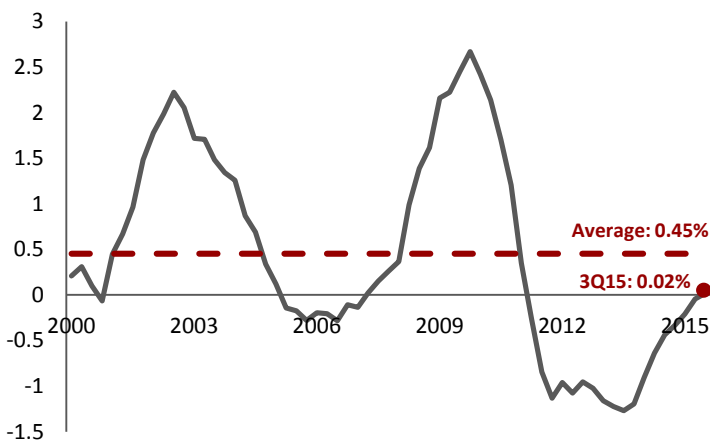
### Theme II – Life After Liftoff

In the six years since the end of the Great Recession, economic performance has been reasonably steady, with GDP growth averaging an unimpressive 2.2% pace. This pace has been good enough to close the output gap and get the economy back to near full employment. This, however, raises an important question: if growth has been averaging around 2.2% over the last few years, with a Federal Reserve that has bent over backwards to support growth, why should we expect GDP next year to continue expanding at the same pace, in light of the new headwind of a normalizing interest rate environment. While monetary policy will almost certainly become less growth friendly in the coming year, we believe that this will be counteracted by a change in stance of the other half of macroeconomic policy – fiscal policy. As seen in Figure 14, government spending was a drag on economic growth during much of the recovery; the drawdown from wars in Iraq and Afghanistan, as well as tight state and

Source: FactSet, IMF

## Key Macro Themes

**Figure 14: Fiscal Policy Impact on GDP Growth**



local budgets, has detracted, on average, 0.8% from US GDP growth since the start of 2011. Fiscal policy became neutral once again in the 3<sup>rd</sup> quarter of 2015, and with the recent \$1.8 trillion package of spending and tax cuts which was just recently passed by the US Congress, we believe that the tightening in monetary policy will not be as big of a burden on GDP growth as some market bears might suggest.

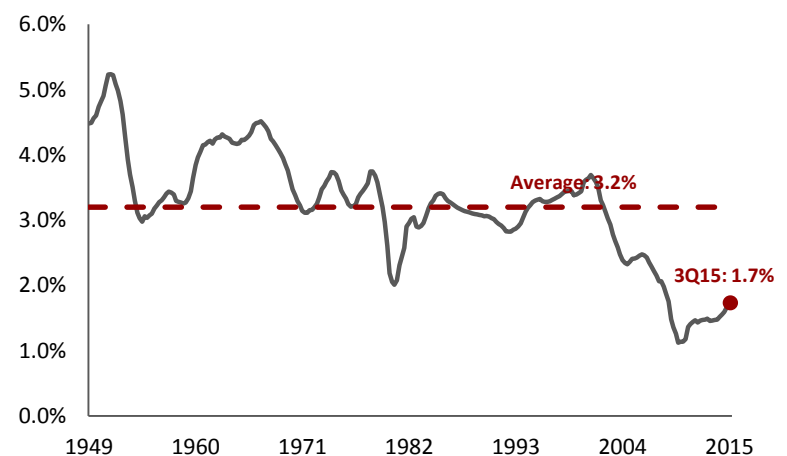
### Theme III – Closing of the Output Gap

In our 2014 report, we cited our belief that the deleveraging cycle that had occurred in the US, coupled with stronger consumer confidence, would lead to a period of above average economic growth, accelerating this prolonged recovery and shrinking the GDP output gap. Here we are one year later and the output gap has hardly changed, ticking upwards from -3.1% to a flat -3% as of Q3 2015. As we look ahead to 2016, we remain confident that the output gap will close, but for different reasons.

While our thesis last year was driven by an accelerated increase in real GDP, this year we foresee a slowing in the other component of the equation, which is potential GDP. With the labour force participation rate sitting at 62.5%, it's lowest level since 1978 and down 4.8% since it's high in April of 2000, we are witnessing a significant plateauing in the growth rate of potential GDP, at a level well below historical average (Figure 15).

With the US economy forecasted to grow by 2.8% in the coming two years, we remain confident in the narrowing of the output gap over the next 3-4 years, although we believe that it will be a result of factors that are detrimental to long term growth. This closing of the gap will only occur in the absence of any significant economic shocks from overseas, but as we outlined earlier, we believe those are becoming less of a likelihood as other DM economies begin to recover.

**Figure 15: Growth Rate of Real Potential GDP**



Note: Fiscal Impact shown on 4-quarter moving average basis  
Source: Brookings, Hutchins Center Calculations, St. Louis Federal Reserve

### Theme IV – China

By now, the story of China in 2015 has been harped on again and again by just about every news outlet on the street. From the magnitude of China's deceleration and deflationary pressures, to the speed at which asset quality worsened and reduced the efficacy of credit growth, to the mixed policy response to the stock market crash, the Red Dragon was undoubtedly the biggest market surprise in 2015.

Already in 2016, we have seen concerns over China reinject a new wave of volatility into the markets. We believe, however, that some of these concerns may be over-exaggerated, building off of our previous notion that sentiment is outweighing market fundamentals.

Of primary concern is China's fast-accumulating debt pile, which at the end of the year stood at just north of \$30 trillion RMB (approx. \$4.6 trillion USD). It is most likely that China will have a large push to convert bank debt into bonds, which would coincide with the efforts to open up the nation's capital markets. Playing into this all would be the internationalization of the yuan, which in 2016, will become part of the IMF's special drawing rights basket. This should be a boon for issuance of yuan-denominated government bills and bonds abroad.

Of course, this will only come to fruition if the market believes that the Chinese government won't devalue the yuan further, as it did in August of 2015. We believe that another sharp devaluation – like the one seen in 2015 – is unlikely. Our view is that Chinese policy makers will want to avoid the ensuing market panic that was witnessed last summer, which brought with it a wave of capital outflows. Having said this, we do not rule out entirely further devaluation of the currency, especially with Japan and Europe pushing their own currencies lower to revive growth. Ultimately, and as we have already begun to see, volatility in the market will continue until investors are convinced that China's slowdown is under control.

While we are keeping a close eye on the current situation in China, one positive that has gone largely unnoticed in the recent downturn is the pickup in Eurozone activity. After turning positive in 2014, the Eurozone is currently growing at a 1.5% annual pace, which more than offsets the decline to world GDP caused by China. The Eurozone, as the world's second largest economic region, accounts for approximately 17% of world output, versus 13% for China. This implies that a 1 percent increase in Euro-area GDP adds \$134 billion to global GDP, whereas the same decrease in China only detracts \$103 billion.

Taken together, China will no doubt be a risk to equity market returns in 2016. We believe that it will present opportunities for individual holdings in our portfolio, as some of them may be unduly punished as volatility returns to the market.

---

Source: IMF, Bloomberg, FactSet

## Valuations

### Valuations: Violently Unchanged

The relatively flat return of the S&P in 2015 has left the state of its valuation virtually unchanged, as exhibited by Figure 16. The forward P/E, P/B, and P/CF multiples all contracted slightly in 2015, leaving us with an unchanged slate when it comes to forming our outlook for 2016.

The key metric to highlight in the figure below is the shrinking gap between the S&P earnings yield and the Moody's Baa bond yield. Last year, we cited this gap as reason to not be alarmed by the lofty valuations on the S&P 500, as the low yielding bonds gave investors little alternative to investing in equities.

As we will outline in the following sections, however, despite the unchanged valuation, a number of other indicators lead us to alter our outlook for the index in 2016.

**Figure 16: S&P 500 Valuation Metrics**

Current S&P 500 Valuations			Historical Perspective			
Valuation Measure	Description	Dec. 31 2015	1-Year ago	5-Year Avg.	10-Year Aavg.	25-Year Avg*
P/E	Forward P/E	16.1x	16.2x	14.1	13.9	15.6
CAPE	Shiller's P/E	25.9	27.3	23.8	23.2	25.3
Div. Yield	Dividend Yield	2.3%	1.9%	1.93	2.1	2.1
P/B	Price to Book	2.6	2.9	2.24	2.25	2.9
P/CF	Price to NTM Cash Flow	11.2x	11.4x	9.84	9.58	11.3
EY Spread	EY minus Baa Yield	0.8%	1.5%	1.92	1.25	(0.7)

\*P/CF ratio is a 20-year avg due to data availability

### The Canary In The Coal Mine

While the S&P 500 earnings yield remains below that of the Moody's Baa bond yield, one alarming lead indicator is the deterioration in high-yield credit over the past year and a half. As one of the big supports for equities for a long time, the rollover in high-yield credit is not a healthy sign for equity performance, as the two tend not to diverge for too long (Figure 17). It is important to note that the increase in high-yield spreads is not only a result of declining energy prices. All 21 of the S&P 500 subsectors have seen a widening in their HY spreads since June of 2014.

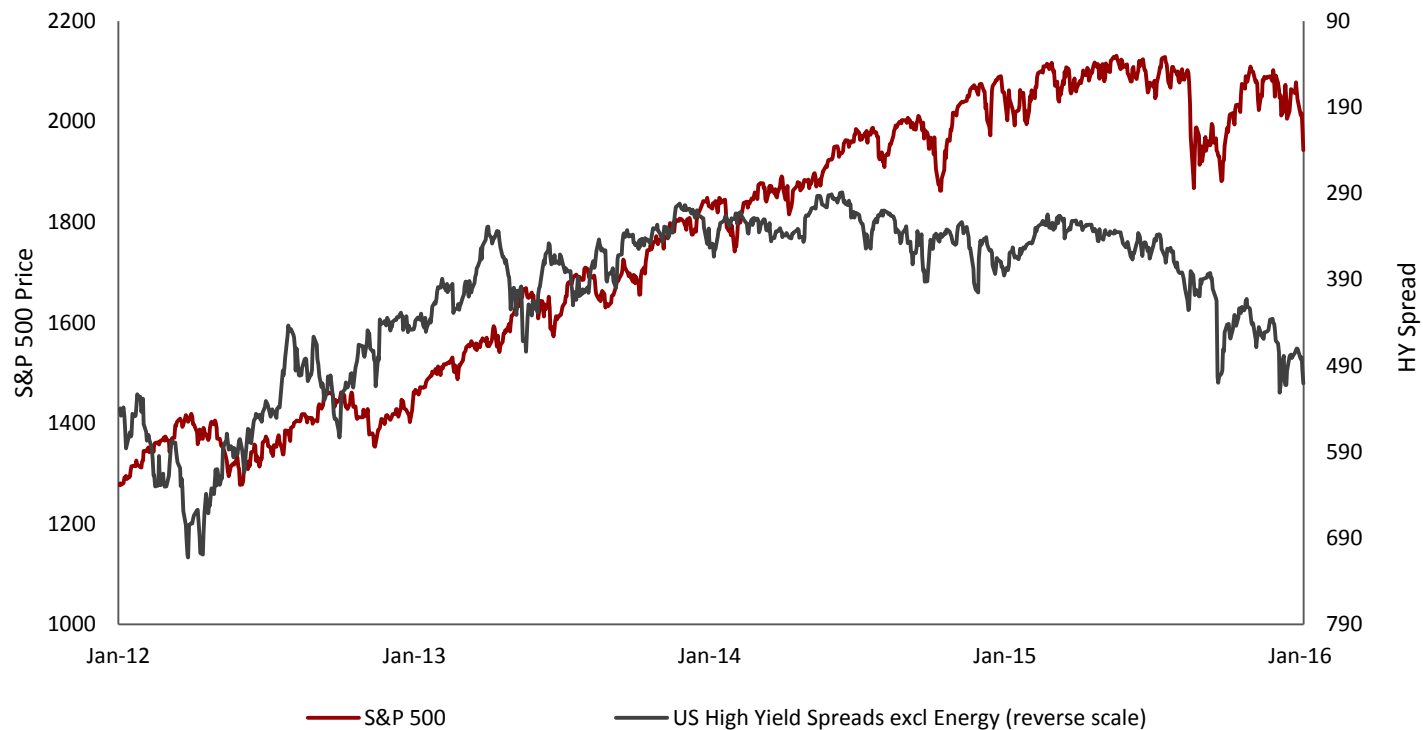
Adding to this concern is the unusual overlap between the rising high-yield spreads and the Fed hiking process. Since 1958, the Federal Reserve has waited, on average, 15 months after a recession to begin the hiking process. December 2015 marked the 78<sup>th</sup> month post recession. With the Fed liftoff coming so late in the proceedings, it raises concerns over the potential impact it will have on weak credit markets.

\*P/CF ratio is a 20-year avg. due to cash flow data availability.

Source: JP Morgan Guide to The Markets



**Figure 17: US High-Yield (ex. Energy) vs. S&P 500**



Source: Bloomberg

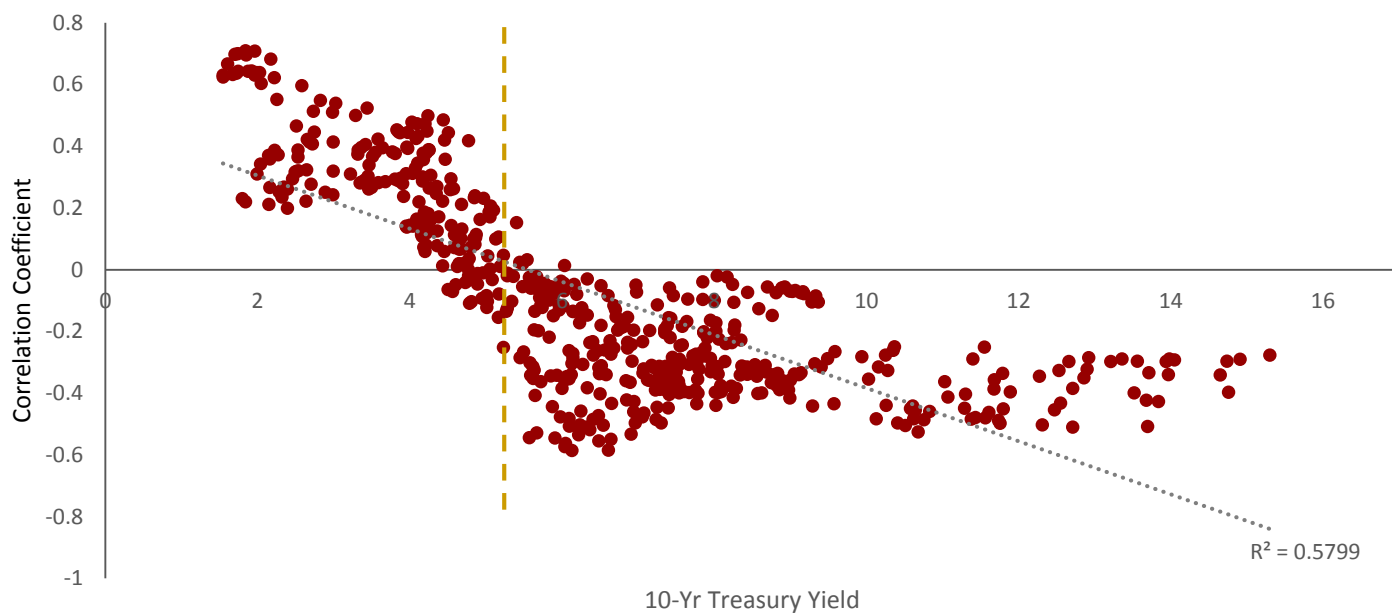
### Rate Hikes Pose Less of a Threat Than Past Examples

The slow economic recovery in the US paved the way for an abnormally long period of ZIRP, which makes the current normalization process very unique in comparison to past cycles. The two key characteristics that stand out are the level at which the Fed is beginning the process from, and the expected length of the cycle. In the past two rate hike cycles (2004 and 1994), the Fed began normalizing rates from 1% and 3%, respectively, which compares to the virtual 0% rate that is the starting block this time around. Additionally, the pace at which the process is forecasted to occur is significantly slower than past cycles. As an example, in both 1994 and 2004, the Fed raised rates back to 5% within 24 months of starting the process. Based on current FOMC dot forecasts, it will be 36 months until we hit even a 3% Fed Funds rate.

All of this goes to say that we do not consider the rise in interest rates in 2016 to be a significant risk. Figure 18 on the next page illustrates that when 10-year treasury yields are below 5%, there is a positive correlation between yield movements and equity market returns.

## Valuations: A Swinging Pendulum

**Figure X: Correlation Between Weekly Stock Returns & Interest Rate Movements**



*Note: Returns are based on price index only and do not include dividends. Markers represent monthly 2-year correlations only.  
Source: Bloomberg, Monthly Data between 1990 and 2014.*

*Debunkery by Ken Fisher, Page 119.*

## Putting it All Together: Where Do We Go from Here?

---

### **(1) A Bumpy Road Ahead...**

If the start of 2016 is any indication, it is that further volatility is to be expected. We have already seen that risks from overseas can influence Fed behavior, and 2016 is no exception. The lack of investor confidence in China will pose a challenge for the Janet Yellen and her team, as it will become increasingly difficult to telegraph their actions based on data they cannot predict.

Furthermore, the event of continued outflows of capital from China will likely lead to sustain the USD's strong run that it has been on since 2011, granted that most other DM central banks are easing their monetary policies. With large amounts of emerging market debt denominated in US dollars, a continuation of this USD bull market would create a negative feed back loop, whereby emerging economies face greater and greater difficulty to meet their obligations.

### **(2) ...but Still A Light At The End Of The Tunnel**

While headwinds from overseas are no doubt already a reality in 2016, we remain confident in the robust US backdrop and fundamentals of the S&P 500. The Fed rate hikes won't break the back of growth in the economy, particularly due to the gradual nature that has been forecasted by the Fed. In the event that we see a more aggressive tightening process this year (ie. More than 100 bps increase) it will likely be due to significantly stronger economic data than expected, or an elimination of fears over Chinese growth, both of which would be a boon for equity markets.

As we reach the later stages of this bull cycle, stock selection and active portfolio management will be as important as ever. We look to the Consumer Discretionary sector to lead the way, on the back of new highs in consumer confidence, and strengthened further by the tightening labour market and decrease in household leverage. The sector also boasts the biggest discount in forward P/E ratio when compared to the 10 sectors within the S&P 500 on a 20-year average basis.

At DCM, we have continued increasing the flow of ideas into the fund, with 23 unique pitches being presented to the group in 2015, of which 14 made it into the portfolio. We now boast a robust watch list of over 10 stocks, which we feel will give us flexibility in the turbulent market conditions of 2016, allowing us to adjust our portfolio as our expectations of the macroeconomic landscape change.

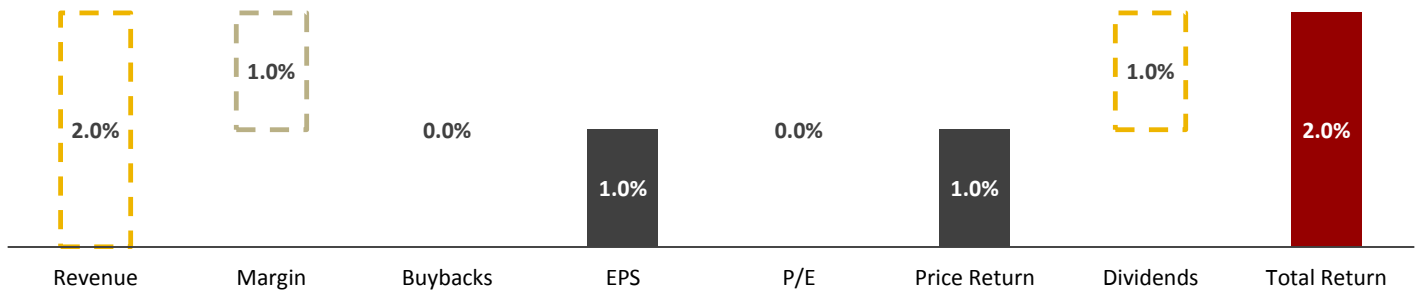
### (3) 2016 Return Forecasts: A Multi-Scenario Approach

We forecast 2016 equity market return drivers based on our views of the macro environment as reflected in the following three scenarios (see Figures 18 a, b & c):

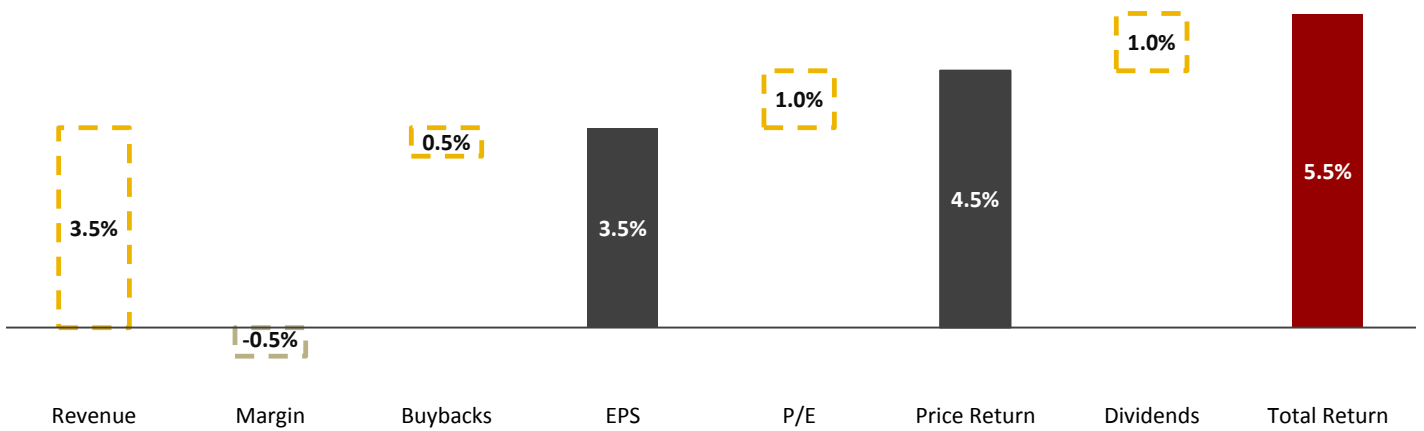
- **Base Case:** In our base case, we project a stabilization in oil prices, as well as the US dollar, allowing for modest 2% top line growth in the S&P 500. We decrease margins by 1% in light of 3 to 4 rate hikes by the Federal Reserve, which subsequently put increased pressure on corporate share buybacks, reducing the effect of artificially boosting EPS growth. We factor in no multiple expansion in the face of an even more mature economic cycle and tepid outlook for emerging markets. Finally, we forecast a 1% increase in dividend contribution, down a percent from 2015, as energy and material companies are forced to reduce distributions in effort to preserve capital under pressured profits.
- **Bull Case:** In our bull case we forecast a pick up in global oil prices, when coupled with a cooling off the USD, aids in 3.5% top line growth in the S&P 500. Should this happen, we believe that the Fed would take a more hawkish stance than it has led on, and tighten at a slightly faster pace than expected, which leads to 0.5% contraction in margins. Solid top line growth enables companies to conservatively grow buybacks, which when adjusted for, brings earnings growth to 3.5% for the year. We factor in a 1% increase in the P/E multiple, as investor fears subside in the light of the pick up in energy prices. Finally, we forecast a 1% increase in dividend contribution to bring total return for 2016 to 5.5%.
- **Bear Case:** In our bear case, we factor in the impacts of a continued decrease in energy prices, coupled with a persistent US dollar that eats away at overseas revenue for US companies. As well, an increasing slowdown in China leads heightened market fears of slowing global growth. We price in a decrease in revenues of 4%, driven by the energy sector. Should this occur, we believe the Fed would hold off on multiple rate hikes in 2016, leading to flat growth in margins for the year. We believe the slowing global growth would lead elevated fears of a recession in the US, and subsequently result in a 5% contraction of the index's P/E multiple. Adding on a 1% decrease in dividends, as revenue pressures affect companies' free cash flows, and we end up with a return on the market of -11%.

# Putting it All Together: Where Do We Go from Here?

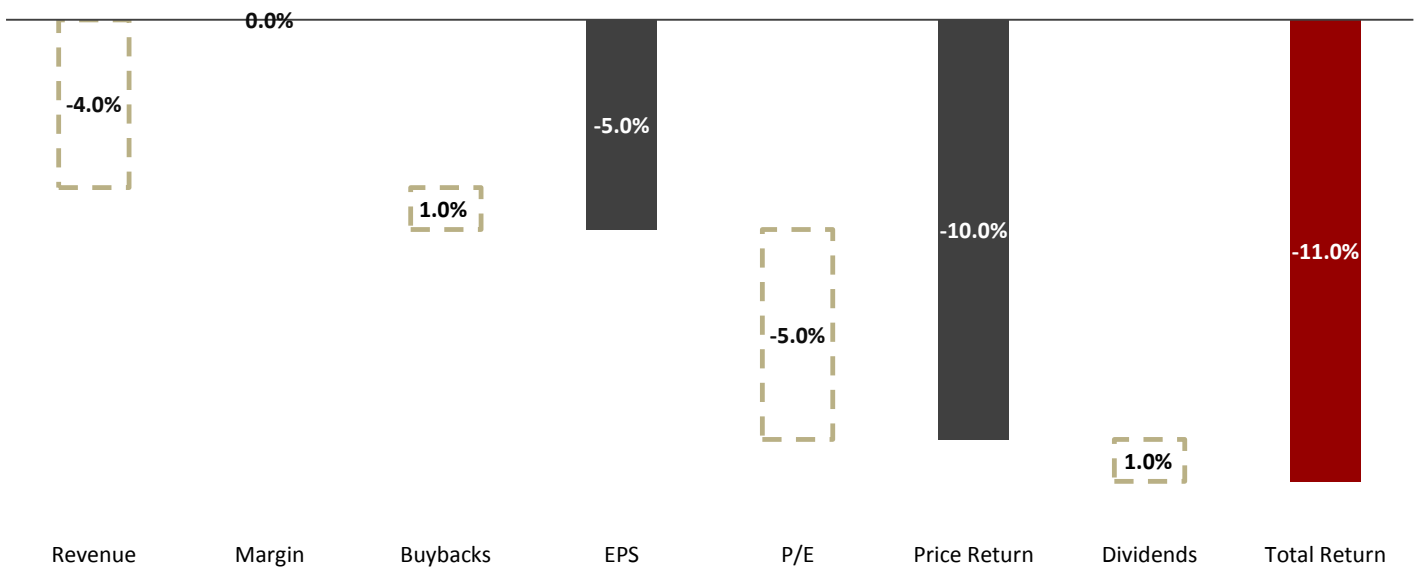
**Figure 20-a): S&P 500 2016 Return Scenarios – Base Case**



**Figure 20-b): S&P 500 2016 Return Scenarios – Bull Case**



**Figure 20-c): S&P 500 2016 Return Scenarios – Bear Case**



Source: DCM Forecasts.

# Risk Management

2015 Portfolio Risk Analysis

*By Christie Wei, Global Risk Manager*





# Risk Management

## Introduction

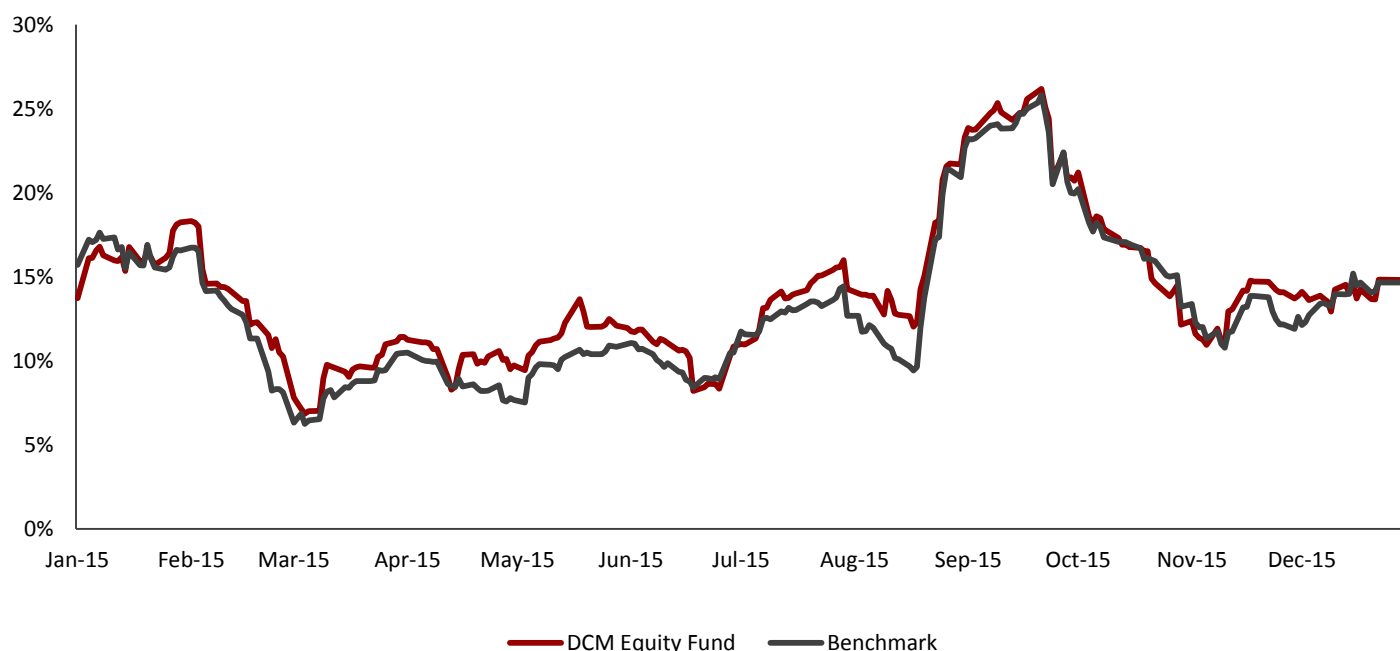
Risk is at the core of every investment decision and DCM utilizes the risk management tools outlined in this section in our portfolio management process. The quantitative analysis includes: rolling volatility, rolling beta risk exposure, Value-at-Risk (VaR), and portfolio variance contribution.

In 2015, the equity fund realized an annualized standard deviation of 14.6%, versus 13.7% for our benchmark. Figure 1 shows the 1-month rolling volatilities of the equity fund and our benchmark.

Volatility movements were largely in line, although our fund exhibited slightly higher volatility in H1. 2015 was slightly more volatile than 2014, when realized volatility was 11.8%. Our VaR estimates were also slightly higher this year compared to last.

Equity Performance Metrics 2015		
	Equity Fund	Benchmark
Annualized Return	5.9%	2.6%
Annualized Std Dev	14.6%	13.7%
Annualized Sharpe Ratio	0.24	0.01
Beta	0.97	
Annualized Alpha	3.4%	
Tracking Error	0.39%	

**Figure 1: DCM Global Equity Fund 2015 Annualized 1-Month Rolling Volatility**



## Portfolio Asset Allocation and Beta Risk Exposure

The equity fund's 2015 beta to our benchmark was 0.97. DCM also monitors rolling beta exposures to various risk factors including WTI spot price, the USDCAD exchange rate, and various market indices, based on monthly ending portfolio weights, allowing us to visualize risk exposure as we change our portfolio allocation.

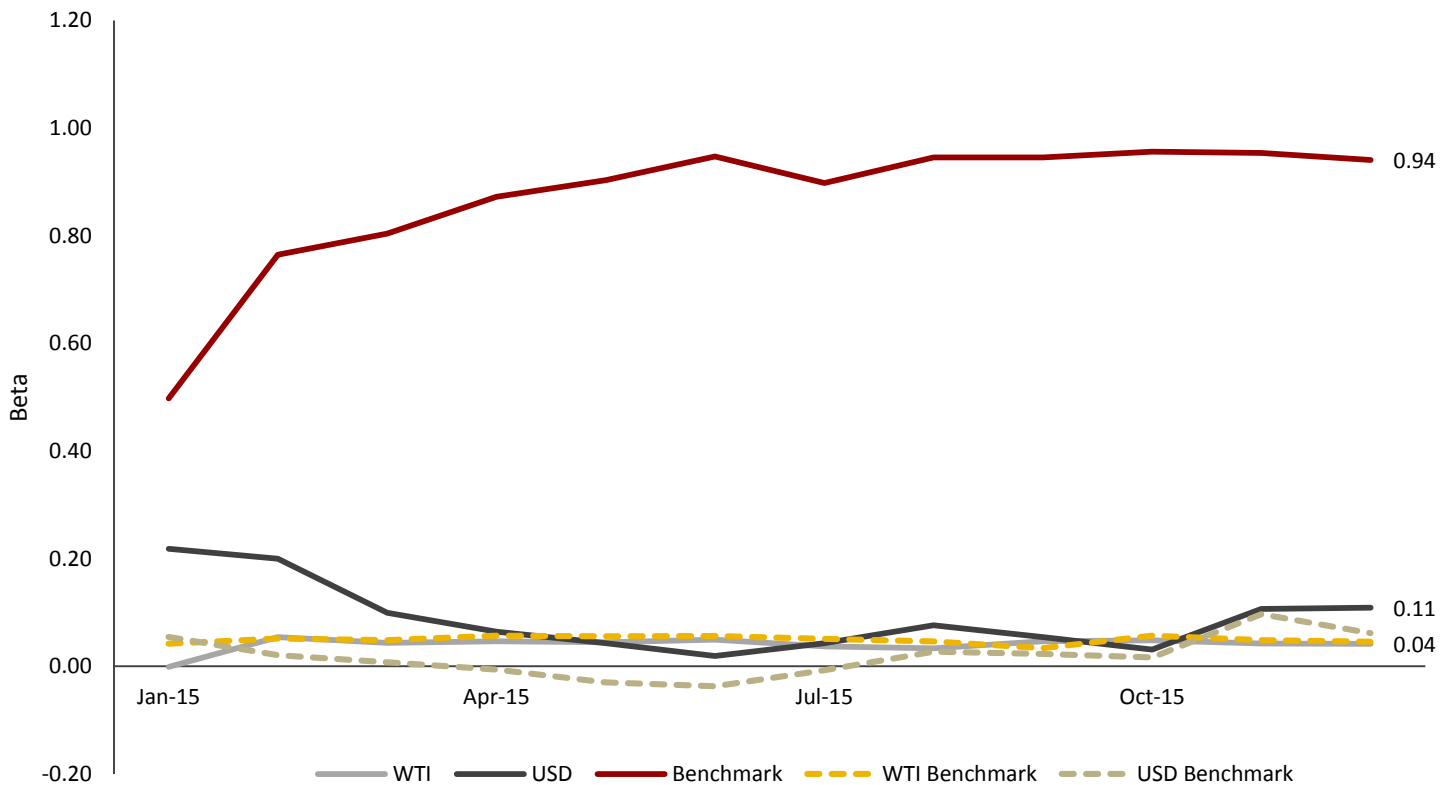
In order to calculate our beta risk exposures at a given month-end, we take our portfolio weightings at the end of that month and calculate theoretical portfolio monthly returns for the twelve months prior based on those fixed weights.

## Risk Management

Those theoretical monthly returns were then regressed against key risk factors in order to calculate the beta to those risk factors, using 1-year of data (Figure 2). The calculated rolling betas highlight how portfolio allocation changes affect our exposures to various risk factors. In 2015, our portfolio's exposure to the benchmark increased from a 1-year beta of 0.50 in January 2015 to 0.94 in December 2015. We also increased our exposure to benchmark ETFs by (i) initiating a ~12% position in the iShares TSX 60 ETF in the beginning of the third quarter as well as (ii) increasing allocations to sector ETFs throughout the year, thus increasing our beta and reducing tracking error. But the increased allocation to ETFs was not done to reduce tracking error per se. Rather it was a result of selling individual holdings that had reached our price targets and parking the cash in ETFs while awaiting new robust investment theses from our analysts.

Aside from market index exposures, the fund's beta to WTI largely held steady, from 0.00 at the start of the year to 0.04 at year-end. In the same period, our beta exposure to USD/CAD declined from 0.21 to 0.11, which can be attributed to an increase in Canadian equity holdings and a reduced USD currency exposure from 58% to 50% in 2015. Relative to the benchmark, the equity fund has a higher exposure to the USD, but similar exposure to WTI.

**Figure 2: 1-Year Rolling Beta Based on Month-End Holdings**



# Risk Management

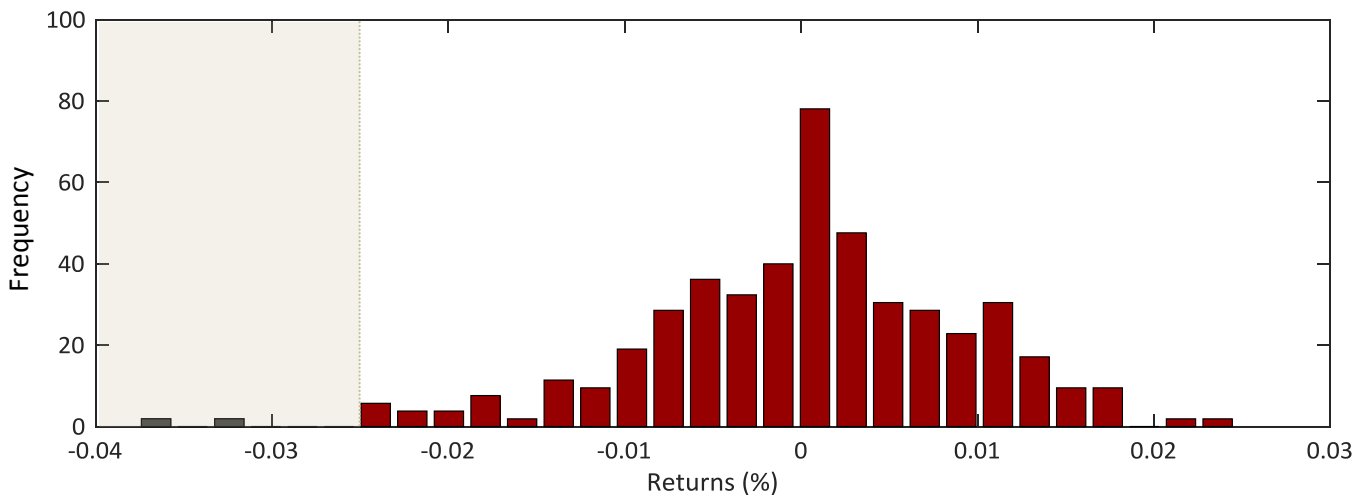
## Portfolio Value-at-Risk

Value-at-Risk (VaR) is another way to visualize the return distribution and risk of a portfolio and estimate downside risk. DCM monitors its 1-Day 1% VaR using three different models: historical simulation, GARCH with a t-distribution, and RiskMetrics. Details of the methodologies and results are presented in Table 1.

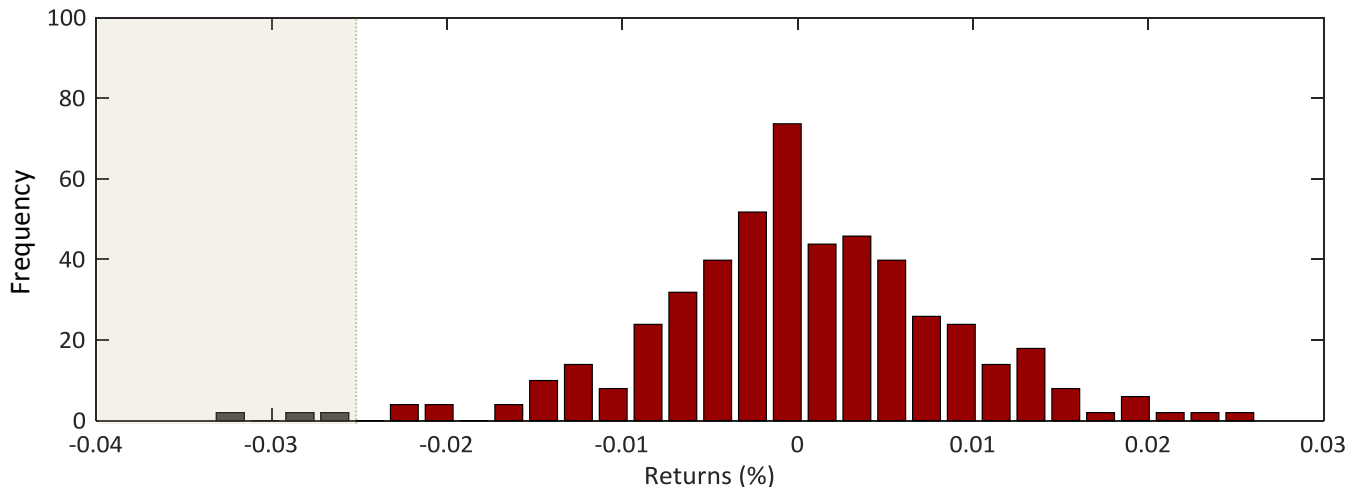
**Table 1: Global Equity Fund Value-at-Risk as at Dec 31, 2015**

Method	1-Day 1% VaR		Commentary
	DCM	Benchmark	
Historical Simulation	2.45%	2.57%	Portfolio returns are simulated using historical individual stock returns. The simulation computes portfolio returns based on historical stock returns using current portfolio weights. The 1% VaR is then simply the 1 percentile return of that distribution.

**Figure 3: Global Equity Fund Historical Simulation as at Dec 31, 2015**



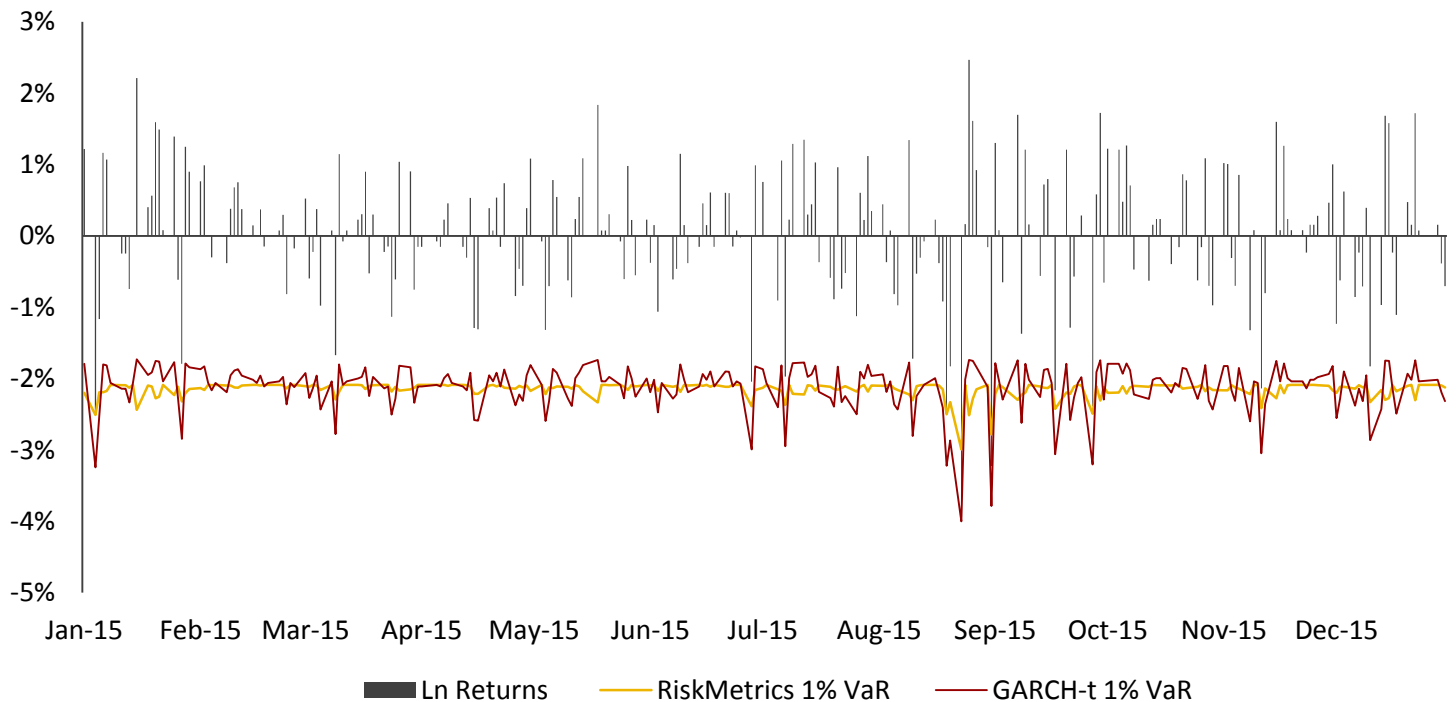
**Figure 4: Benchmark Historical Simulation as at Dec 31, 2015**



# Risk Management

Method	1-Day 1% VaR		Commentary
	DCM	Benchmark	
GARCH using t-distribution	2.26%	2.12%	It is widely known that stock returns are non-normal. To account for this, we combine GARCH volatility forecasting with a standardized student-t distribution. Our GARCH t-distribution model parameters were estimated using maximum likelihood estimation. As shown in Figure 5, DCM violated 1-Day 1% GARCH-t VaR twice in 2015, a reasonable amount given that 1% of ~252 trading days per year is equivalent to 2 or 3 days.
RiskMetrics Model	2.15%	2.02%	Our RiskMetrics VaR model uses a lambda value of 0.94 (a widely accepted estimate for most asset classes) and an initial variance equal to 2015 mean realized variance. Similar to our historical simulation and GARCH-t models, RiskMetrics 1% VaR was violated twice in 2015 between August and September (Figure 5).

**Figure 5: Log Returns versus 2015 1-Day 1% VaR Estimates**



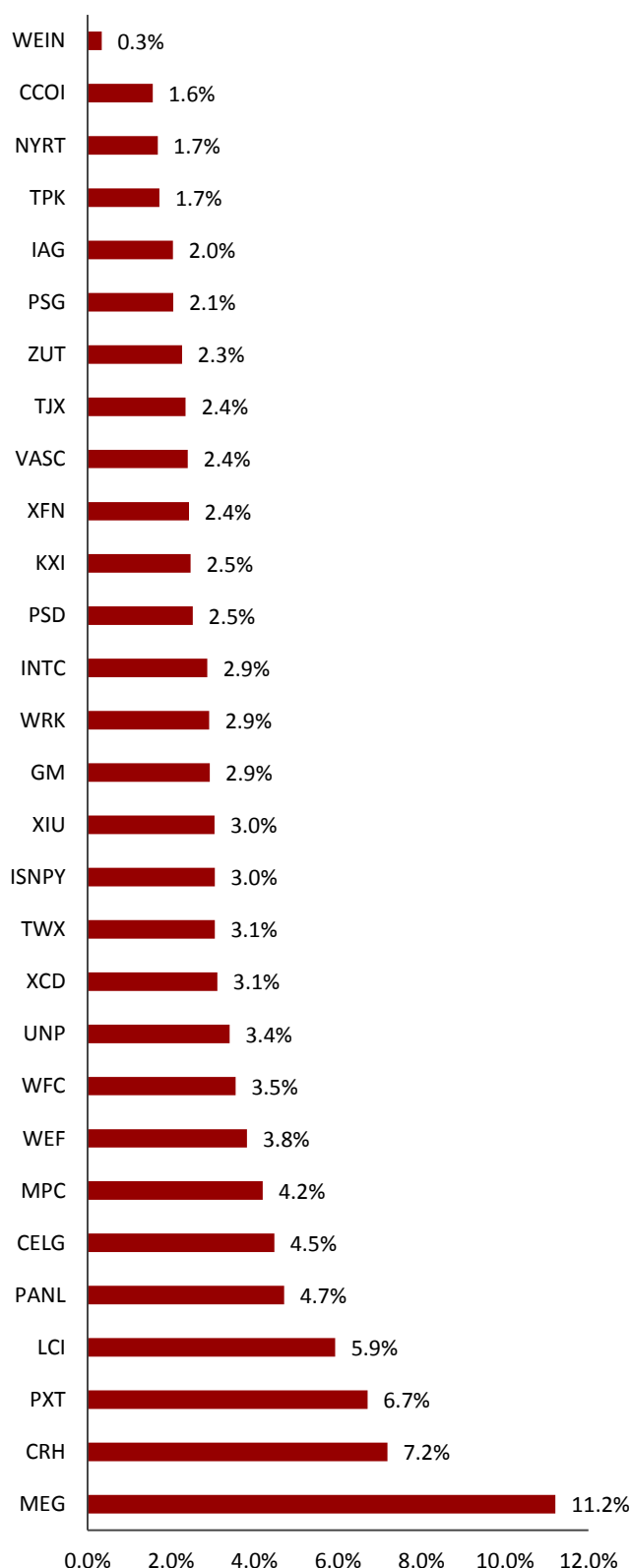
## Contribution to Portfolio Variance

In addition to monitoring portfolio volatility, beta exposures, and downside risk, we also monitor the contribution of individual holdings to overall portfolio variance. Each stock's contribution to portfolio variance is based on that stock's weighting, variance, and covariances to all other stocks. Contributions to portfolio variance are then normalized to sum to 100%. Results are shown in Figure 6.

A majority of our portfolio variance can be attributed to our healthcare and energy holdings, given that the top four contributors to portfolio variance fall into these two sectors. The largest contributor to portfolio variance remained unchanged from 2014, with MEG Energy accounting for 11.2% of 2015 portfolio variance. This is unsurprising given the riskier nature of exploration and production companies, on top of a volatile oil price environment.

The second largest contributor to portfolio variance was CRH Medical, a recent addition to our portfolio, and much of CRH's volatility can be attributed to its strong 142% 2015 return. In total, our healthcare sector exposure accounts for approximately a fifth of our total portfolio variance. Going forward, we will keep a close eye on our healthcare holdings, as well as our overall healthcare sector exposure, which is currently 1.3% overweight versus our benchmark.

Figure 6: Contribution to Portfolio Variance (%)



# Financials Sector

2015 Review & 2016 Outlook

*By Philippe Rich, Sean Saggi, Olivier Babin, and Neil Corber*





# 2015 Sector Performance

## 2015 Performance Review

The DCM Financials group returned 19.1% in 2015, vs. 2.3% for our sector benchmark (Figure 1), as each of our five holdings significantly outperformed their subsector index (Figure 2).

## Financials Total Shareholder Return

The Financials sector as a whole was certainly not immune to the macro factors that dominated headlines in 2015 (oil, Europe, China, Fed rate hike). Nevertheless, the sector managed to increase top line revenue growth and increase margins through effective cost-cutting programs. These positives, however, were largely offset by decreases in P/E ratios (-11.2% in Canada, and -4.8% in the US) amid increased uncertainty regarding the health of the economic recovery (Figure 3).

Figure 1: DCM Financials Performance

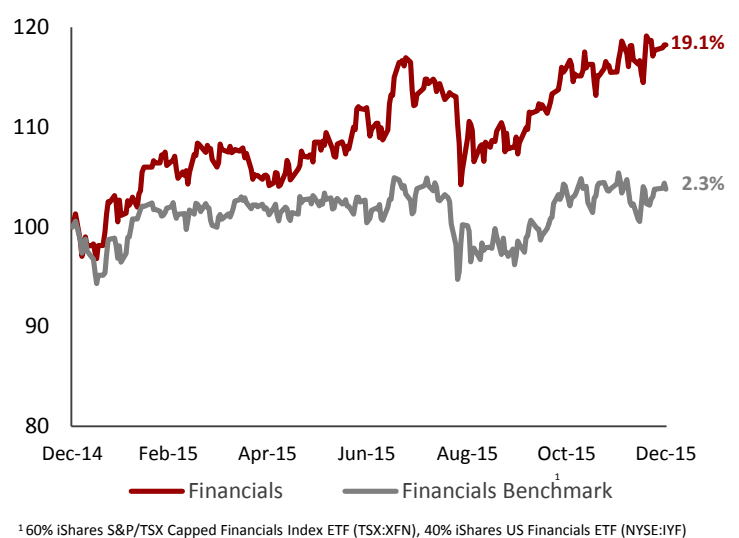
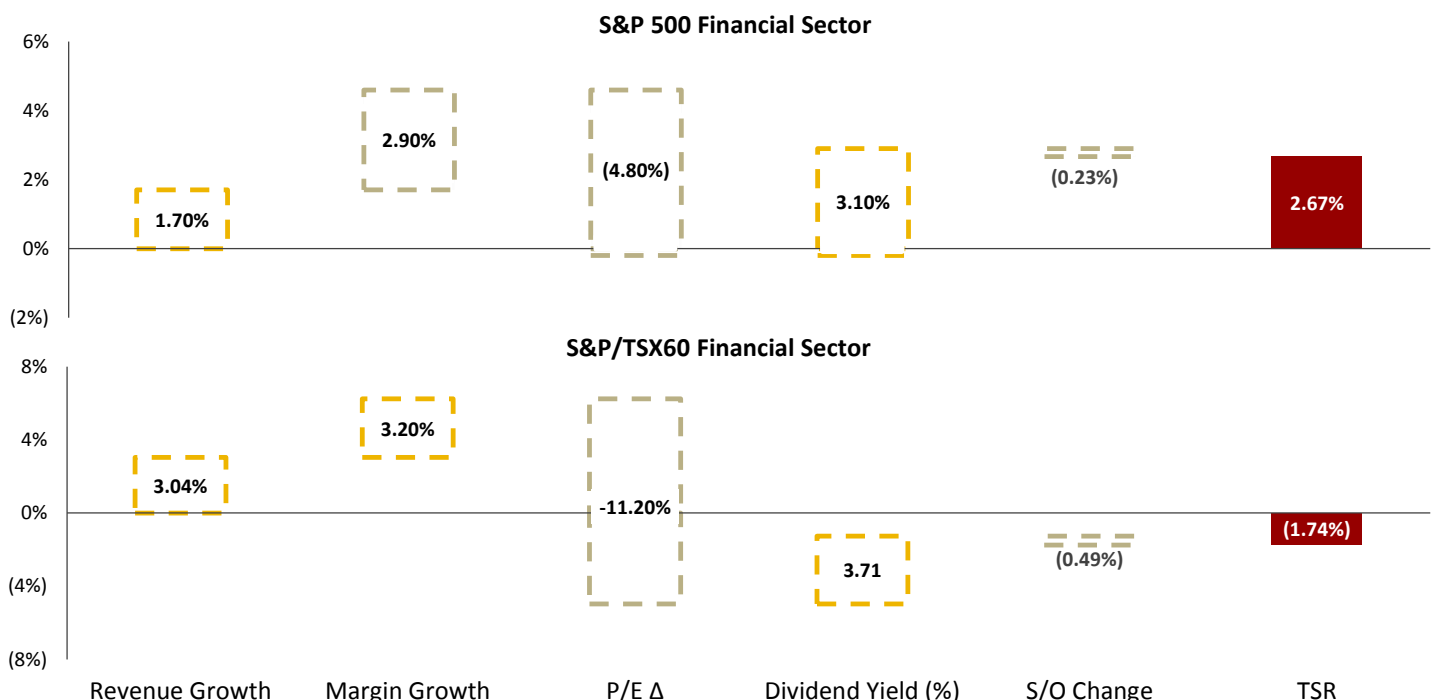


Figure 2: DCM Financials Weighted HPR Versus Their Sub-Sector Benchmark

	Wells Fargo	Intesa Sanpaolo	NYRT	IAG	WEIN
Weighted HPR	20%	35%	29%	15%	3%
Sub-Sector Benchmark Return	1%	(7.7%)	(2.8%)	1%	(2%)
Benchmark Selected	S&P US Bank ETF	iShares Europe Financials ETF	DJ Office & Industrial REIT Index	Canadian Lifecos	US Regional Bank ETF
Outperformance / (Underperformance)	19%	43%	32%	14%	4%

Figure 3: 2015 Total Shareholder Return Breakdown

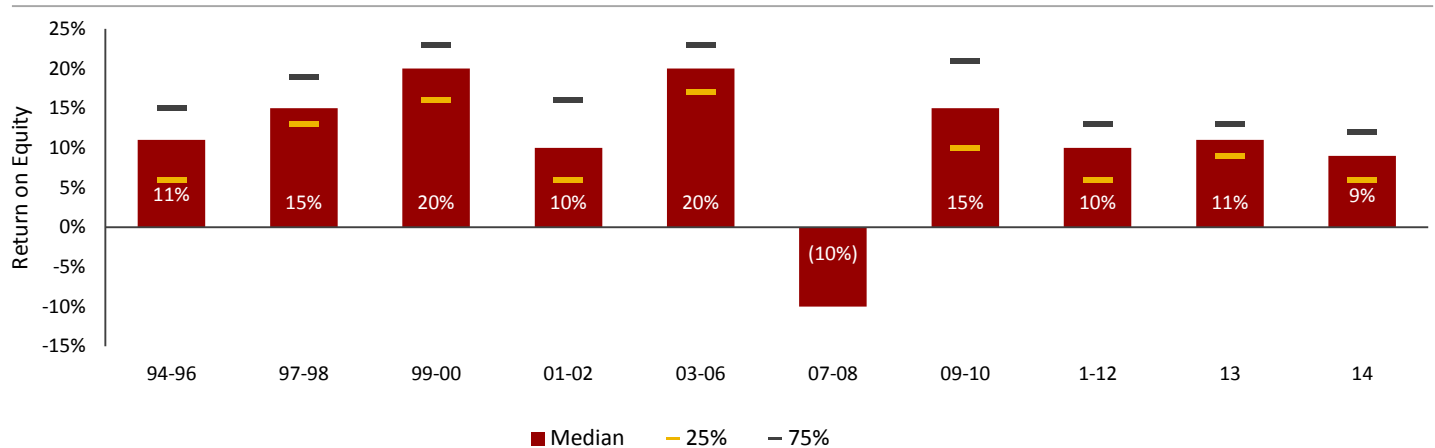


# 2015 Sector Performance

## Banks Review

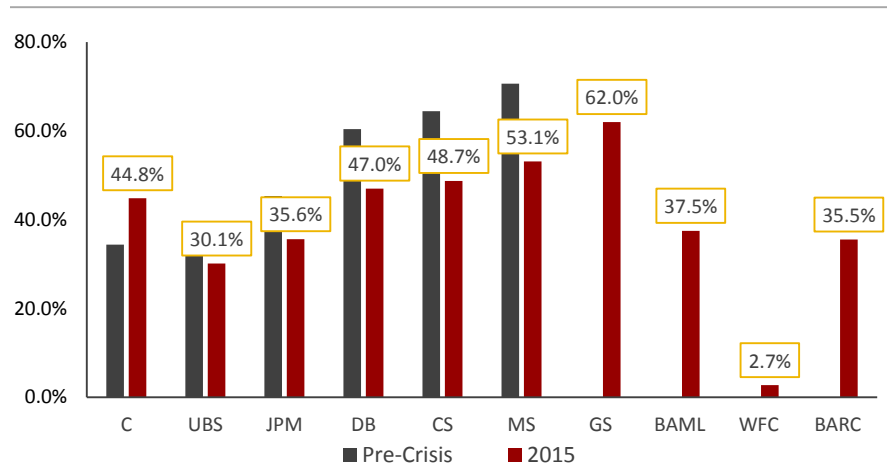
The post-crisis period has been marked by a significant decrease in banks' return on equity (Figure 4), primarily due to 1. stricter regulatory constraints on balance sheets, requiring lower leverage and less risk, and 2. the low interest rate environment negatively impacting net interest margins (NIMs).

**Figure 4: Wholesale & Investment Banks Return on Equity**



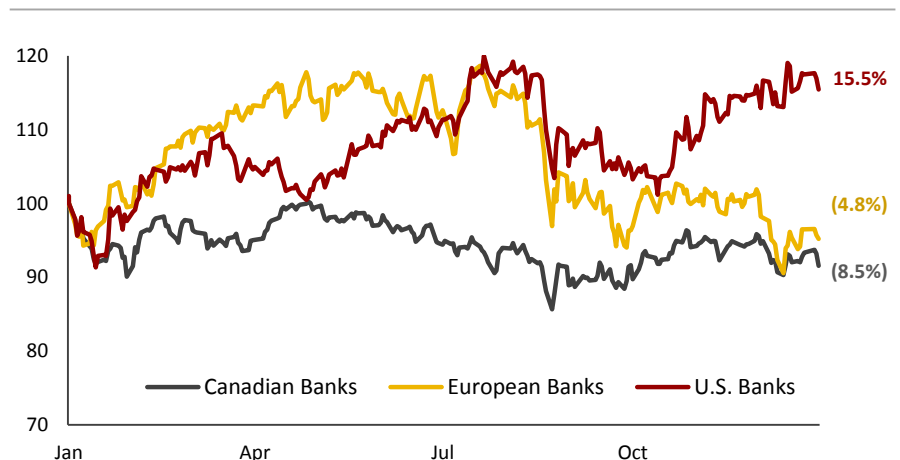
As a consequence of increased regulatory constraints, the largest banks continued to scale-back exposure to capital markets in 2015 (Figure 5). Currently, only two of the ten largest global banks generate more than 50% of their revenue from their financial market arm. This is down from six out of ten during the pre-crisis era. Commercial banking has become more prevalent, thus increasing the importance of the level of net interest margin under which banks operate.

**Figure 5: Financial Market Revenue as % of Total Revenue**



In 2015, US banks returned 15.5% while European banks and Canadian banks ended the year down 4.8% and 8.5%, respectively (Figure 6). The divergence in performance reflects the discrepancy in economic and political realities across the globe. While US banks surfed the rate hike and economic recovery wave, European banks drowned in political turmoil and Euro uncertainty, while Canadian banks sank with oil prices.

**Figure 6: 2015 Banks Performance by Region**



## 2015 Sector Performance

### U.S. Banking

Going into the December 2015 meeting, the Fed funds futures market was pricing in a 76% chance of a rate hike. With the hike finally coming to fruition, bank stocks reacted positively, as an increase in interest rates generally have net positive impacts on banks (see US Banking Outlook).

Banks were also affected by the oil price collapse through their loan portfolios. Large banks are relatively better suited to deal with the decline in oil prices relative to their smaller counterparts due to better loan portfolio diversification. For example, J.P. Morgan and Wells Fargo have energy-related exposure in the low single digits, whereas smaller banks, such as BOK Financial, have exposure in the mid-to-high teens range (as a percentage of their loan portfolio). Throughout the year, we have seen smaller banks set aside reserves to counteract the decline in value of their energy loan portfolios.

Regulations have had a profound impact on banks since the financial crisis. The designation of Systematically Important Financial Institution (SIFI) has given many C-level executives nightmares due to higher capital requirements, stringent regulations, and prudent stress tests. For example, in an effort to de-designate itself as a SIFI, General Electric began unwinding its finance arm, with divestitures totaling \$157 bn in 2015. Similarly, some have reported that AIG is pursuing a spin-off of its mortgage insurance business to appease activist investors who fear it will soon be recognized as a SIFI. In addition, investors witnessed numerous private equity firms enter the role of traditional banks, as traditional banks were forced to exit select businesses following regulatory changes. We expect this trend to continue moving forward.

### European Banking

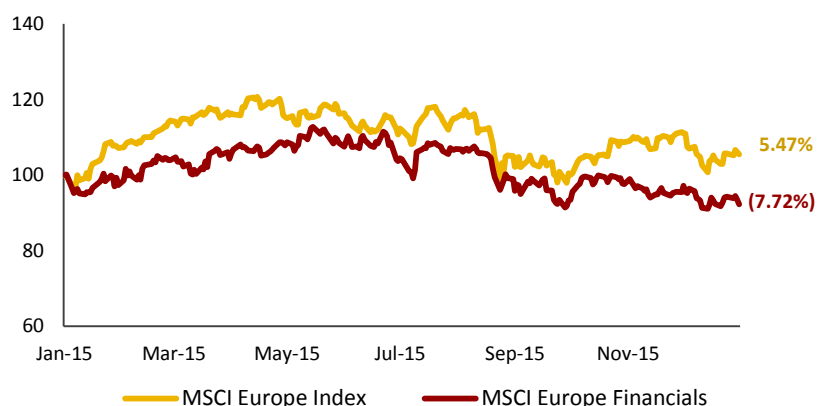
European Financials underperformed the overall market in 2015. The MSCI Financials Index declined 7.72%, versus a gain of 5.47% for the overall European markets (Figure 7). The large underperformance was partially driven by the lack of lending in many Eurozone countries, as well as the continued presence of bad loans on banks' balance sheets, estimated to amount to \$909 bn.

In October 2014, the ECB and European Banking Authority announced the results of their Comprehensive Assessments. These so called stress tests served two purposes: 1. clean up banks' balance sheets, and 2. attract investors to European financial institutions by proving that the institutions are stable. The stress test sparked a round of preemptive equity raisings, which officials hoped would drive banks to shed bad loans in 2015. Throughout the year, banks continued to offload bank debt in an effort to cut costs and restructure their balance sheet.

Despite the extra capital, balance sheet pressure remained. Minimal economic growth combined with ultra-low interest rates continued to pinch bank profits. At the same time, bad loans continued to pile up in countries such as Greece and Italy. More recently, the ECB stated that Greece's four largest banks need to raise a total of \$16 bn. Additionally, European banks have been cutting their workforces, evidenced by this past quarter where Deutsche Bank stated that they would reduce head count by 35,000.

Since the start of quantitative easing in 2015, central banks in the euro zone have purchased ~\$400 billion in debt. The QE program has quickly become the main driver of the Eurozone's bond market, with sovereign yields tumbling to record lows within days of the program launch. Similar to the impact of quantitative easing in the United States, the ECB's QE program has put downward pressure on NIMs, with larger banks impacted more than smaller banks.

**Figure 7: 2015 Europe Banks Performance**



## 2015 Sector Performance

### Canadian Banking

Canadian banks suffered in 2015, albeit not as much as the broader Canadian market, returning -8.48% compared to the TSX return of -11.09%. Banks were choked on all sides: NIMs decreased ~4%, and ROE dropped ~6%. Investors ran away from Canadian bank stocks, with P/TBV (Price to Tangible Book Value) free falling ~20% (Figure 8).

Squeezed by lower net interest margins, banks focused on remaining lean and improved their efficiency ratios by 1.5%. Banks also tightened their credit exposure, which resulted in both their allowance for loan losses and non-performing loans to decrease by an average of 2.5%. Worries about capital ratio requirements were also a negative toward the end of the year. The sudden drop in equity, write-off of assets, and increase in risk-weighted assets (42% from energy sector credit downgrades) all contributed to the rapid decline in capital ratios. National Bank of Canada and the Royal Bank of Canada were forced to issue shares at the end of 2015 to maintain a healthy cushion above common equity tier 1 capital ratio requirements.

**Figure 8: 2015 Canadian Banks Metrics**

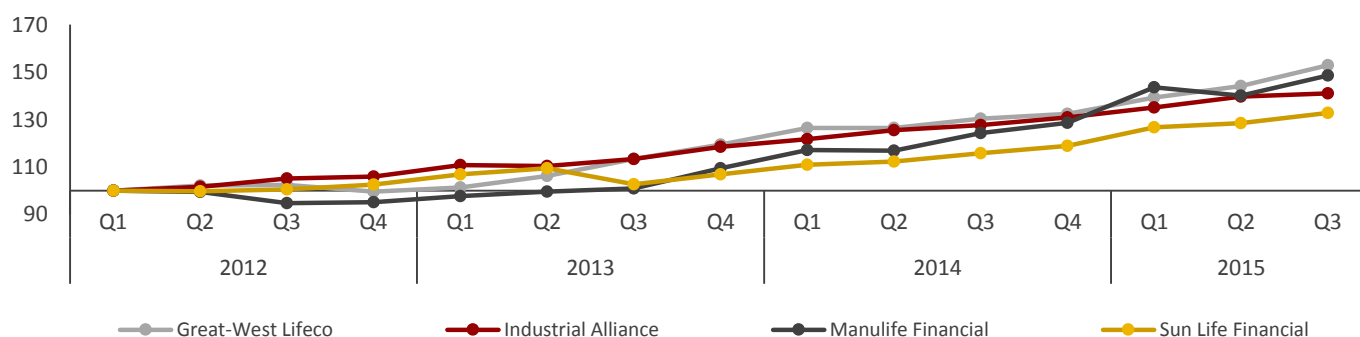
Big Five Canadian Banks	NIM	Efficiency Ratio	ROE	P / TBV	Non-Performing
	% Change	% Change	% Change	% Change	Loans
Royal Bank of Canada	(8.1%)	1.9%	(2.3%)	(20.1%)	6.6%
Toronto Dominion	(6.0%)	1.7%	(11.1%)	(23.5%)	(0.5%)
CIBC	(2.4%)	1.0%	1.8%	(11.6%)	(8.8%)
Bank of Montreal	(3.1%)	1.2%	(10.1%)	(19.3%)	(13.4%)
Bank of Nova Scotia	0.2%	1.5%	(9.0%)	(24.5%)	2.5%
<b>Average</b>	<b>(3.9%)</b>	<b>1.5%</b>	<b>(6.1%)</b>	<b>(19.8%)</b>	<b>(2.7%)</b>

### Canadian Lifecos

2015 was a flat year for Canadian life insurance companies, with a 0.5% return for the sector index driven by relatively flat long-term Canadian and US yields.

In 2015, Canadian lifecos focused on deploying large amounts of capital to shareholders through strategic and accretive acquisitions, share repurchases, and dividend increases. On average, the big four undertook 6 capital deployment actions each last year; a drastic increase compared to the previous year. Additionally, their book value per share has been rapidly increasing (Figure 9). Weighing on lifecos' performance is a sector-wide decline in wealth management products AUM, mostly due to declining equity markets in Canada. More specifically, equity market downturns mostly impact lifecos' bottom lines through 1. lower fees collected by their investment arms, and 2. an accounting obligation to write-off expected future revenues of universal life funds. The growing popularity of passive investment vehicles also contributed to the decline in AUM. Industrial Alliance suffered the most in 2015, with its wealth management arm experiencing large outflows. We believe this is a market overreaction to the loss of one of its largest mutual fund distributors, Laurentian Bank (see IAG holding review).

**Figure 9: Canadian Lifecos Book Value Per Share [Indexed]**



## 2015 Sector Performance

In 2016, Canadian lifecos should continue to benefit from increasing US rates. Indeed, under the Canadian Institute of Actuaries' deterministic methodology, Canadian lifecos increase their assumed IRR and URR when interest rates increase, thus decreasing the amount of reserves they have to set aside, and in turn increasing their earnings. Also, given that the duration of lifecos' liabilities is much longer than that of their assets, the decline in market value of their assets that accompanies an increase in yields is more than offset by the positive impact of increases in interest rates on the present value of their liabilities. All four top players have been adamant on their intention to continue deploying their excess capital. If all excess capital were to be deployed for share buybacks, 2016E ROEs would increase by 1-2% (Figure 10).

**Figure 10: Potential Increase in Canadian Lifecos' ROE from Excess Capital Deployment**

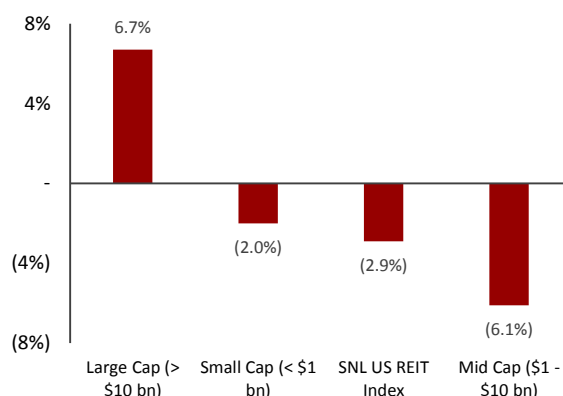
	Capital Levels		Excess Capital		Assumed buyback price	2016E ROE		Increase to 2016E ROE
	MCCSR <sup>1</sup>	Leverage	\$MM	Per Share		Theoretical buyback	Current 2016E ROE <sup>2</sup>	
Great-West Lifeco	247%	25.4%	2,461	2.49	32.00	16.5%	14.5%	2.0%
Industrial Alliance	221%	24.5%	0,338	3.31	39.00	12.6%	11.5%	1.1%
Manulife Financial	229%	24.5%	4,163	2.11	17.00	11.5%	10.3%	1.2%
Sun Life Financial	226%	23.5%	1,952	3.19	37.00	13.3%	11.9%	1.4%

1. Minimum Continuing Capital and Surplus Requirement  
2. Street consensus

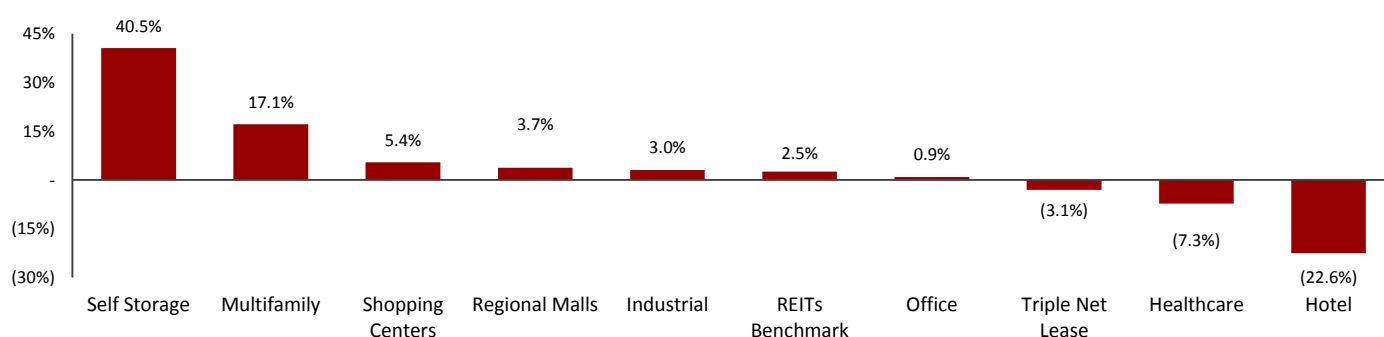
## US REITS

2015 was a year of uncertainty and volatility for US REITs, fueled by constantly changing expectations of the timing of the Fed's rate hike. Large-cap REITs outperformed considerably in 2015, partly due to their defensive nature and institutional investors' preference for stability this year (Figure 11). The returns varied widely across US REIT sub-sectors, with hotel, healthcare, and triple net in the red, while self-storage and multifamily outperformed (Figure 12). The return distribution is very much in line with sub-sector interest rate sensitivity: with interest rates rising at all maturities, longer duration lease sectors (triple net and healthcare) sharply underperformed, while the short-term lease vehicles (storage and multifamily) sharply outperformed.

**Figure 11: Large Cap REITs Outperformed**



**Figure 12: REIT Performance by Sector**



We are exposed to the US REIT space through New York REIT, the largest holding in the financials sector. NYRT's unique geographic positioning and quality of lease portfolio insulated it from investors' interest rate uncertainties and allowed it to outperform the DJ Industrial and Office REIT index by as much as 32%. Also, office properties in large metropolitan cities like New York have historically been more closely correlated with the positive economic cycle as opposed to interest rates.

## U.S. Banking

As we look to the year ahead, we see a variety of mixed trends affecting the US banking sector.

On the upside, we expect 1) higher interest rates will alleviate NIM pressure and contribute to revenue growth, 2) stronger economic growth in the US will fuel top-line growth (through accelerating loan growth), and 3) continuing improvement in operating efficiency will improve efficiency ratios.

On the downside, the main risk remains regulatory risks, as the implementation of Dodd Frank and Basel III could heavily weigh on banks' operating performance. The energy sector could also continue to be a drag on bank performance, depending on the oil market. Also, the potential flattening of the yield curve could limit NIM expansion.

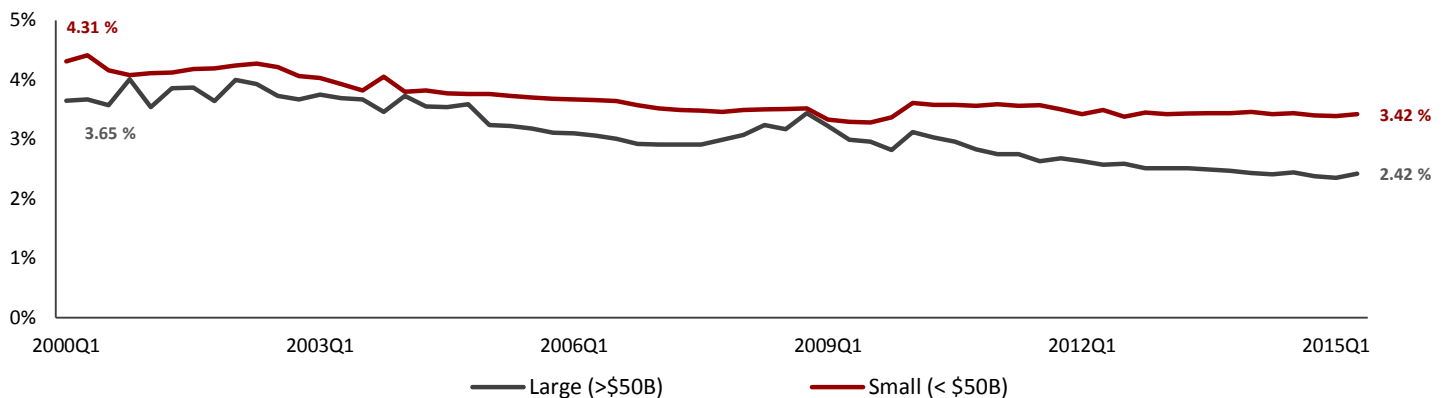
Below, we outline our views for what we believe will be the main drivers of banks' performance in 2016.

### Rising Interest Rates and Net Interest Margins (NIMs)

Since 2010, the NIMs of large banks, such as Wells Fargo, have fallen 70bps, whereas the NIMs of small regional banks have fallen only 20bps (Figure 13). This divergence has been driven by two main factors: 1) prior to the financial crisis, small banks, on average, offered higher rates on deposits relative to larger banks. As such, following the decline in interest rates, the smaller banks were able to decrease the cost of their liabilities more than the larger banks; 2) big banks have larger holdings of trading assets and therefore are relatively more reliant on interest income. Hence, large banks experienced a steeper decline in interest income earned on "other assets" in the past few years, with interest rates floored and government yields declining. Thus, solely based on NIMs, we expect larger banks to outperform smaller banks in a period of rising interest rates.

Also, US banks may be at an advantage given their heavy domestic focus, which allows them to pass on the increase in interest rates to borrowers quickly. At the same time, banks are able to delay passing the benefit to savers for as long as possible. These factors will likely drive bank valuations higher.

**Figure 13: Large vs. Small Banks Net Interest Margins**





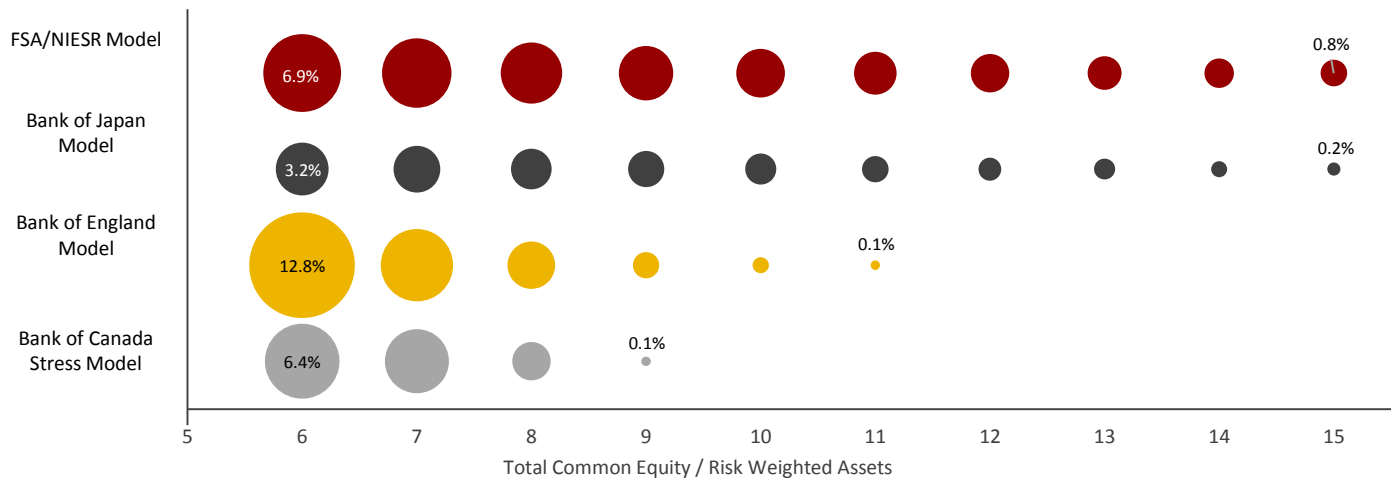
# 2016 Outlook

## Regulation

A major theme in 2016 will be the uncertainty surrounding the implementation of Basel III and the related effects on banks' performance.

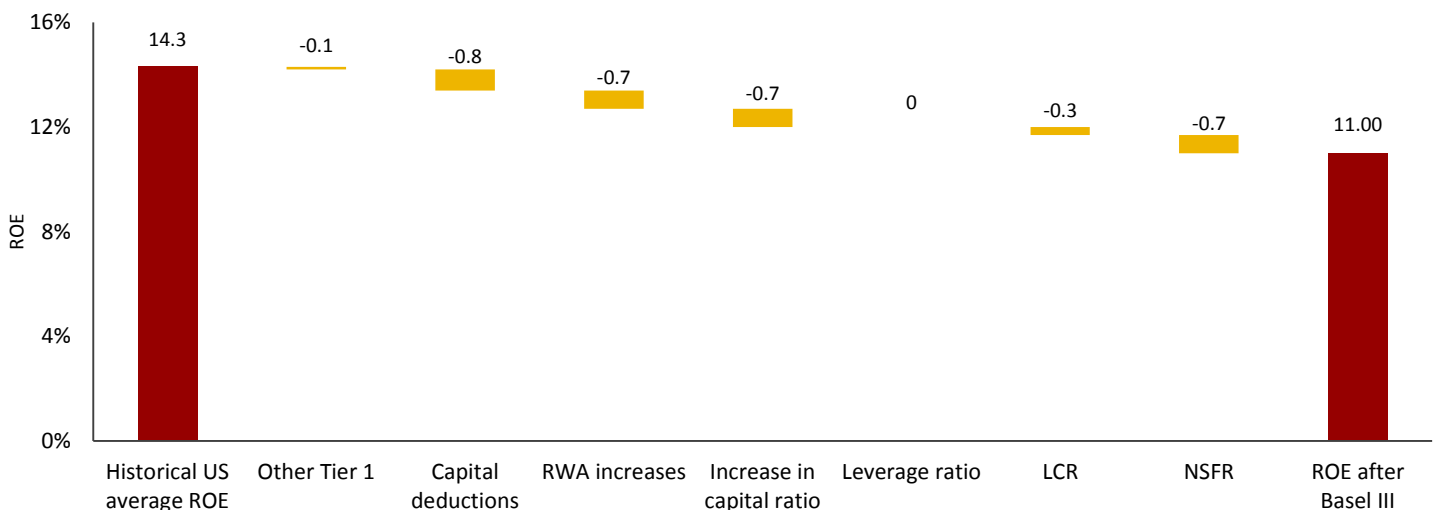
Several studies show the benefits of Basel III regulations on financial stability. Different central banks have different estimates, but, unsurprisingly, all of them come to the same conclusion: increasing Total Common Equity to Risk-Weighted Assets ratios should decrease the probability of a crisis

**Figure 15: Annual Probability of Banking Crisis For Different Capital Ratios**



With Basel III still being implemented, there is little empirical evidence of the actual impact of new capital requirements on the banking industry and the financial system as a whole. The repercussions of unprecedented regulations on the economic system and on banks' operations divide economists, regulators, and industry participants. Leaders of these larger banks fear pressures on multiple fronts: profitability and ROE, changes in demand from short-term to long-term funding, reduced lending capacity, reduced investor appetite for bank equity, and forced legal entity reorganization. McKinsey estimates that banks' ROE could be lowered by as much as 320 bps by regulations, assuming 0% pass through (Figure 16).

**Figure 16: Estimated Impact of Basel III On Banks' ROE**



### Industry Consolidation

The state of bank consolidation turned an important corner during the second half of 2015. Since the financial crisis, bigger financial institutions had been reluctant to acquire competing banks. However, this has not prevented large financial institutions from gobbling down a larger piece of the banking revenue pie. Indeed, following the financial crisis, the top 5 US banks increased their share of the market's revenue from 34% to 48% in 2015 (Figure 17). With rising interest rates favouring large banks as previously discussed, we see large banks continuing this market share growth trend.

We expect continued consolidation in the small community bank market, defined as assets under \$1 billion. Drivers of consolidation include: 1) need for large banks to increase scale in order to remain economically viable; 2) most Midwest markets have very limited growth opportunities, so growth by acquisitions is a driving factor; 3) increased costs of regulation; 4) easing of regulatory concerns for M&A, and 5) the need for synergies and scale to drive shareholder value in a low growth environment. Accordingly, we initiated a position in West End Indiana Bank, driven by both business-specific reasons, as well as our positive outlook towards industry consolidation in the small community banking market.

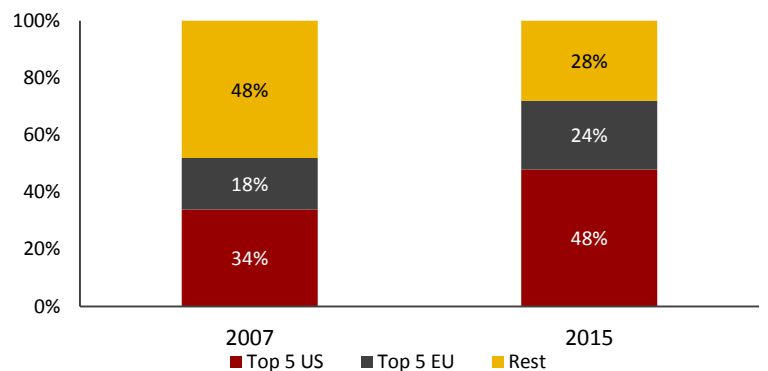
### European Banking

Turning our focus across the pond onto the European banking sector, we foresee two trends dominating headlines in 2016.

First, quantitative easing will continue to remain an important topic. In December 2015, Draghi extended the planned length of the QE program, as inflation continues to remain well below target. However, we believe QE will have minimal impact on the economy, as: 1) the banking system continues to have \$909 billion of bad loans on its balance sheet, leaving it impaired; 2) corporate investment remains insensitive to lower interest rates; 3) inability of stimulus to reach small and medium businesses who are responsible for +75% of job creation. Accordingly, we expect minimal loan growth and continued pressure on NIMs throughout the year

Secondly, we believe bank rationalization will be a key theme in 2016, driven by a need to improve returns. The pursuit of higher returns will continue to be implemented through two opposing strategies: asset dispositions (for big banks), and consolidation (for small and mid-sized banks). Big banks will shrink, as regulation reduces the benefits of scale, making greater size a capital and P&L cost. Big banks have already begun to condense, and we expect continued streamlining and exits from select business lines and geographic regions. In contrast, the single supervisory mechanism (SSM) provides a framework, as well as incentive, for further bank consolidation among the mid- and small—cap banks. SSM has redefined single jurisdiction to include the entire Eurozone. Since scalability of banking exists within a single jurisdiction, it is providing incentives for consolidation among medium-sized banks.

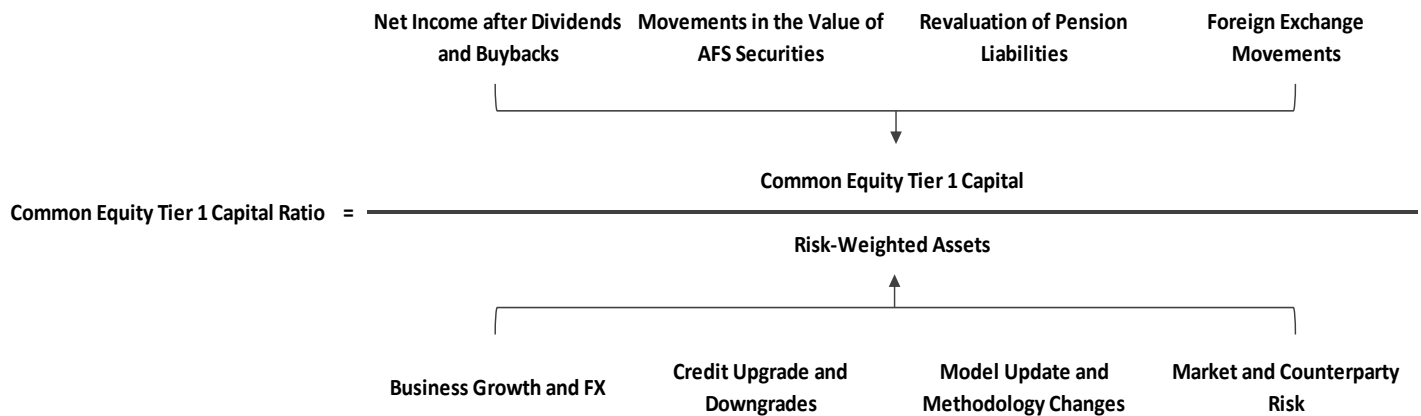
**Figure 17: Banks Revenue Market Share**



## Canadian Banking

We expect 2016 to be another rough year for Canadian banks. Weaker economic growth, low oil prices, sidewise USD/CAD trading, and increased capital volatility could all put some pressure on Canadian banks' common equity tier 1 (CET1) capital ratios. Indeed, the outlook for all of the drivers of the numerator and denominator of the capital adequacy ratio (Figure 18) point to substantial capital tightening.

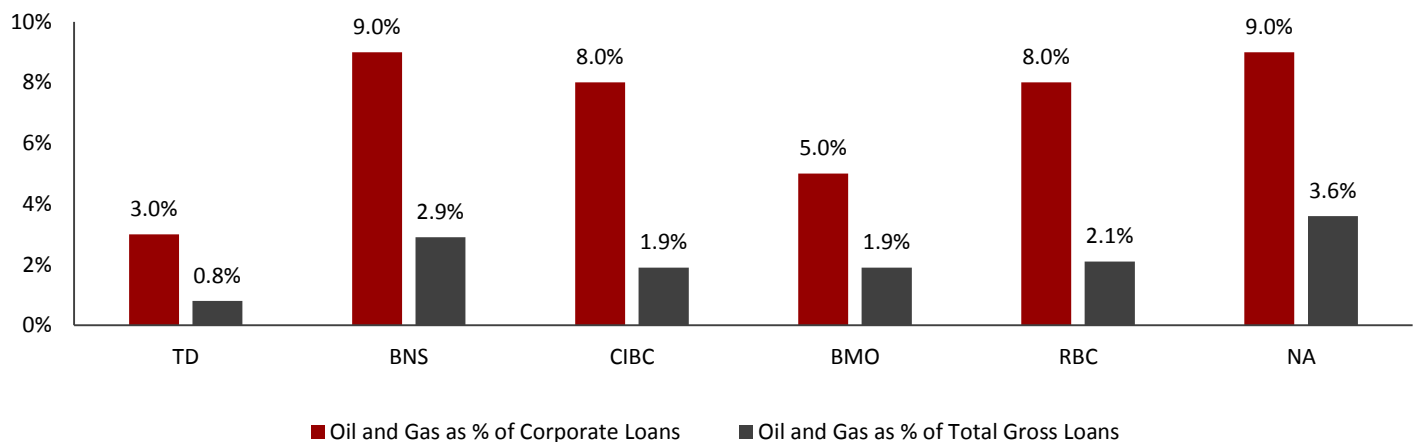
**Figure 18: Key Drivers of Capital Ratios**



In the extreme case where all wholesale credit held by banks is downgraded by one notch (i.e. sustained sub-\$30 oil, recessionary period in Canada), the CET1 capital ratios would decrease by as much as ~500bps, bringing the group average to 9.5% - below banks' "comfortable" level of 10% and very close to the 8% limit.

Banks' performance in 2016 will greatly be affected by the Canadian energy sector and oil price levels. Oil and gas street tests at all banks show massive increases in credit losses at \$30-35 oil in 2016. This has led management at all banks to place expense management as a top priority in the current environment. Although there have not been any large energy-related write offs at the big banks, we monitor closely the relative exposure of the top six. National Bank of Canada and the Bank of Nova Scotia have the highest direct exposures, each having 9.0% of their loan portfolios exposed to oil and gas companies, and ~3% of their loans exposed to individuals in the industry (Figure 19).

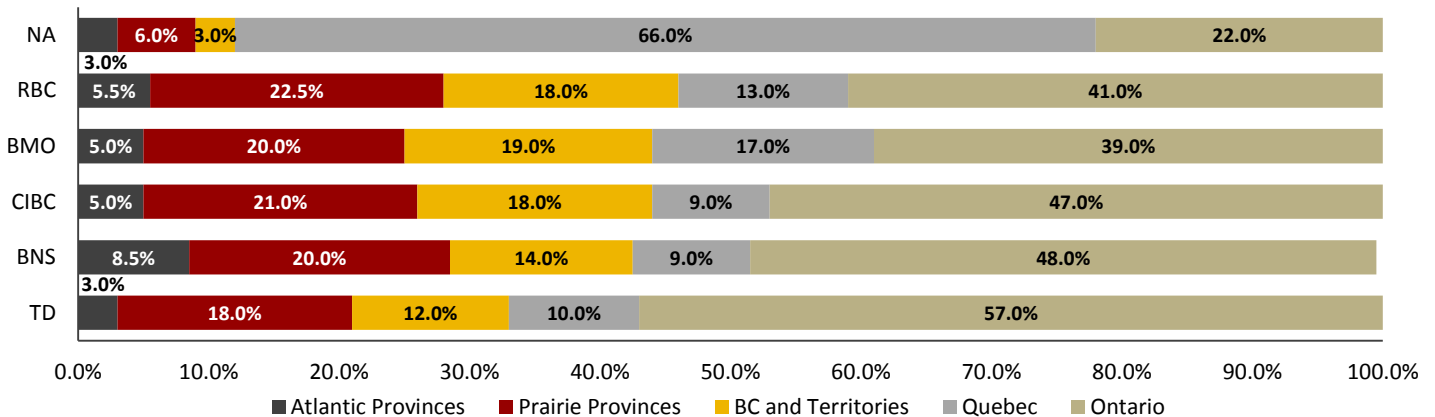
**Figure 19: Canadian Banks Direct Exposure to Oil Through Loan Portfolios**



## 2016 Outlook

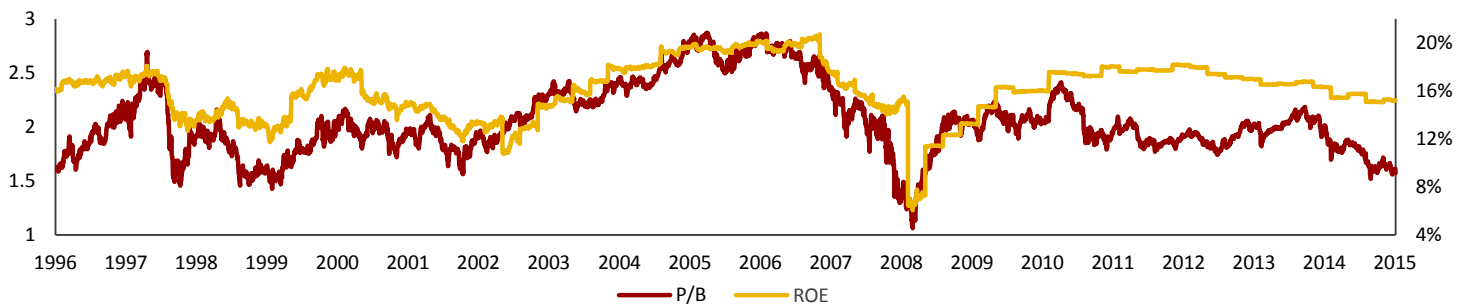
In addition to the direct exposure through loans to oil companies, it is important to consider the macroeconomic risk of the Canadian banks' indirect exposure to oil. In the energy-producing provinces – Prairie and Atlantic provinces – we will likely see spillover effects to bank asset qualities beyond solely direct oil loans. With ~25% of their portfolios in 'riskier' provinces, we expect Canadian banks to feel the pain of sustained lower prices. Royal Bank of Canada and the Bank of Nova Scotia lead the pack with the highest indirect exposure, while National Bank is by far the least exposed (Figure 20).

**Figure 20: Canadian Banks Indirect Exposure to Oil Through Energy-Related Provinces**

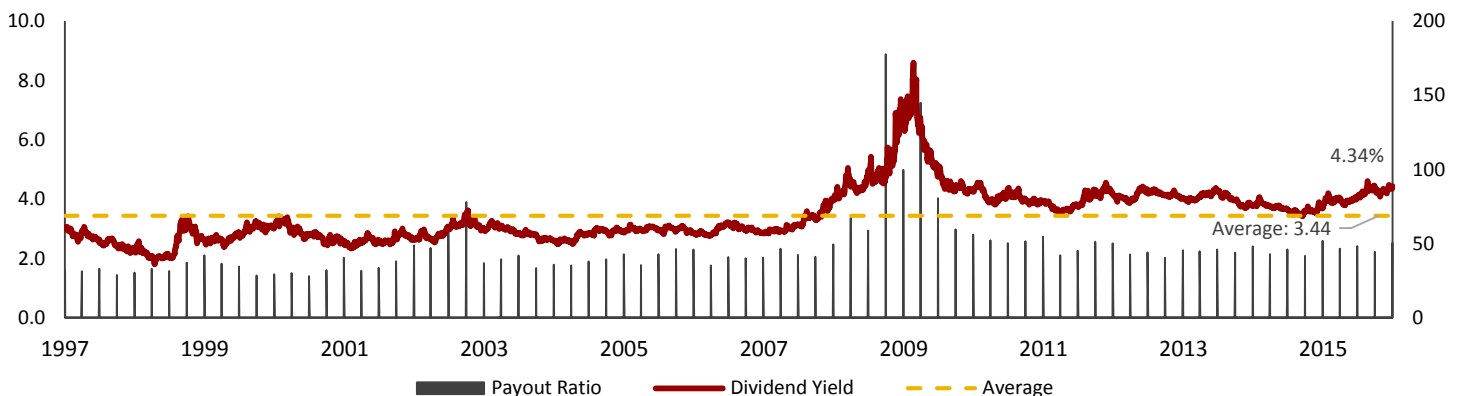


Canadian bank valuations appear attractive compared to historical levels. P/B ratios and ROE widened to an unprecedented gap in 2015 (Figure 21), suggesting the market is pricing in future lower earnings growth rate and a higher cost of equity due to increased riskiness. At 4.34%, the current dividend yield is also attractive compared to historical levels (Figure 22). Still, we remain very cautious on the Canadian banking sector as we expect significant write-offs on the banks' oil & gas loan portfolios. Going into 2016, we prefer names with lower oil and gas exposure, as well as larger US retail divisions.

**Figure 21: Historical P/B and ROE of Canadian Banks**



**Figure 22: High Dividend Yield Compared to Historical Levels**



## U.S. REITs

Overall, we see a lot of upside for US REITs in 2016 – especially office REITs – on the back of strong US economic backdrop, positive impact of interest rate increase (as we explain below), and demand-supply imbalances. Our convictions for US REITs performance in 2016 rely on three fundamental analyses: interest rate sensitivity, valuation, and the US economy.

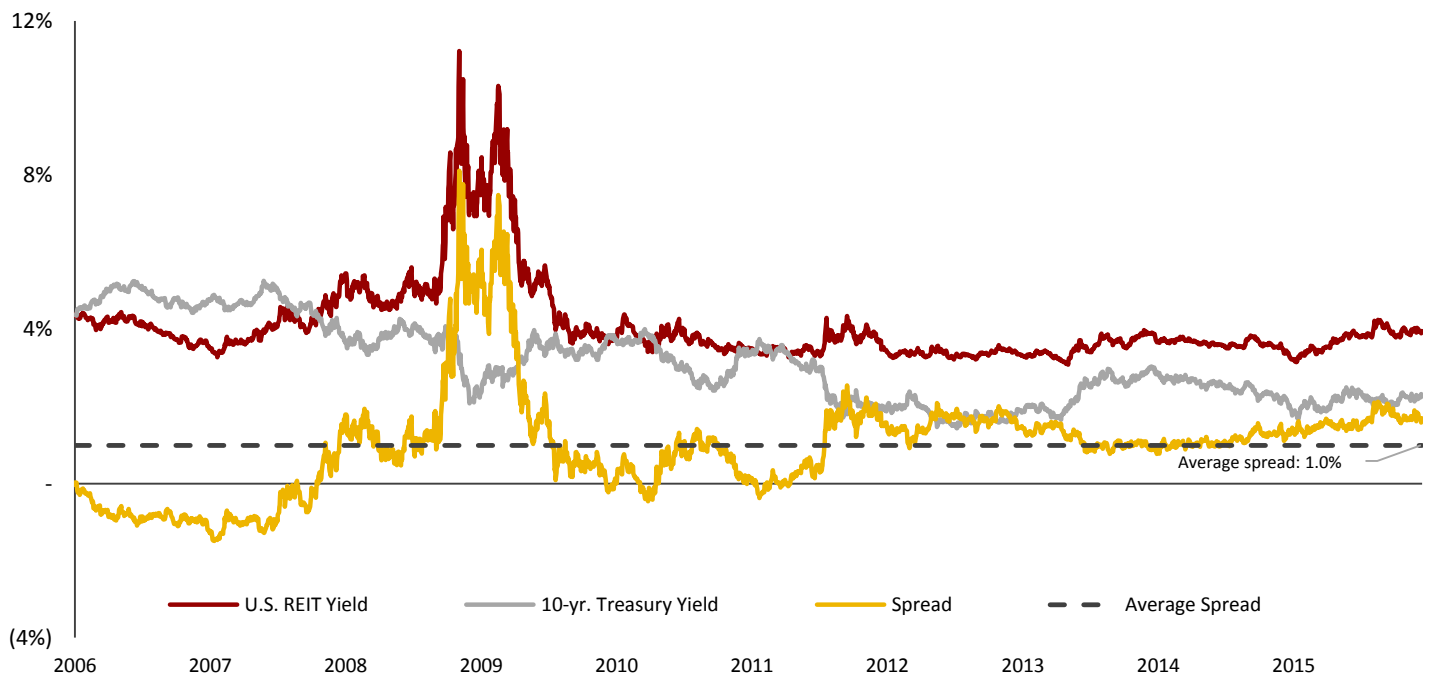
Conventional investor wisdom suggests that higher interest rates are a negative for REITs. We argue that the correlation is not as strong as investors assume and that the current Fed tightening cycle will not negatively impact US REITs. Rising interest rates are seen by the public to have three main negative consequences on REITs’ operations and performance. First, rising interest rates increase the cost of debt. However, US REITs have managed to reduce their debt levels to historical lows, reducing the impact of this relationship.

Second, conventional wisdom suggests that rising interest rates lead to higher cap rates, which naturally decreases asset valuation. However, looking at previous periods of Fed rate hikes, we actually see that cap rates declined as Fed fund rates increased (Figure 23). Finally, rising rates make REITs’ dividends less attractive and incite investors to seek higher yielding opportunities elsewhere. We agree that this is likely to have an impact on short-term share price performance for the US REIT space, however, with ~50bps Fed hike currently priced into REIT stocks, we see the negative sentiment to be short-lived. More importantly, US REITs’ yields are above historical average spreads to the U.S. 10-year treasury yield, which suggests REITs are undervalued on that metric (Figure 24).

**Figure 23: REIT Cap Rate Changes**

Periods of Fed Fund Rate Hikes	Cum. Change (bps)	
	Fed Funds Rate	Cap Rate
Sep 1987 – Feb 1989	214	-20
Feb 1994 – Feb 1995	364	-10
Jun 1999 – May 2000	128	0
Jun 2004 – June 2006	373	-140

**Figure 24: Attractive Current U.S. REIT Yield Spread**

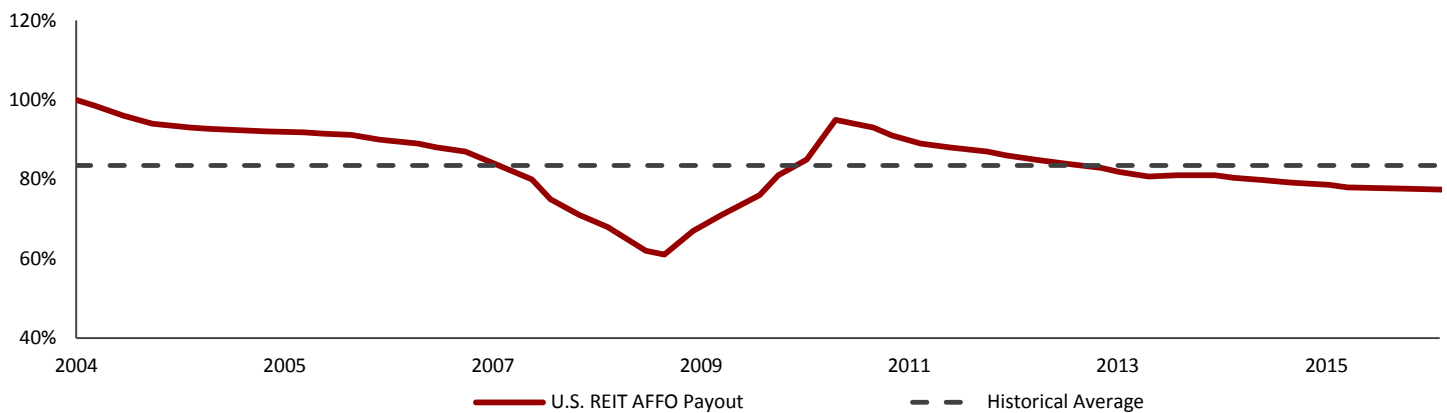


## 2016 Outlook

As interest rates start to increase and investors focus on yield spreads, REITs should be positively repriced. Also, the current adjusted-funds-from operations (AFFO) to dividend payout ratio is at its lowest level ever, excluding the 2008 recession, which suggests further dividend increases to bring the payout closer to historical levels (Figure 27). Indeed, this low dividend payout ratio provides a cushion for REITs to increase dividends, and more importantly, it indicates that REITs are approaching the minimum payout ratios required to maintain REIT status – implying a dividend increase at or above AFFO growth. From a behavioral point of view, dividend increases will send a positive signal to investors, and comfort investors who are worried about the impact of interest rates on REIT stock price.

As interest rate fears subside, REIT stocks should rebound on the back of strong underlying economic fundamentals. Indeed, the US positive economic cycle should drive top-line and net operating income growth. More specifically for office REITs, US employment growth and limited new supply should translate to continued same property NOI growth. We remain confident in our exposure to the industry, New York REIT (NYSE: NYRT), given the historical outperformance of office REITs following fed rate hikes (Figure 25). Further details are provided in our holdings review section.

**Figure 25: AFFO Payout Ratio Lower Than Historical Levels**



# Financials Sector

Holdings Review





# Industrial Alliance Group (TSX: IAG)

## Company Overview

- Founded in 1892, Industrial Alliance is an insurance and financial service company headquartered in Quebec City, Canada
- The company operates through four main segments: individual insurance, individual wealth management, group insurance, and group savings and retirement
- Industrial Alliance currently serves three million people across Canada, and is the 4th largest insurance provider in the country

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$44.13
S/O (mm)	101.9
<b>Market Cap.</b>	<b>\$4,497.6</b>
+ Total Debt	\$2,363
+ Minority Interest	\$0
+ Preferred Shares	\$375
- Cash	\$656
<b>Enterprise Value</b>	<b>\$6,579.6</b>
Beta (1-Year)	1.11
Dividend Yield	3.0%
52-Week High	\$45.85
52-Week Low	\$38.76

## Catalysts

- Replacement of IFRS 4 will put forward the relative conservatism of Canadian accounting standards for Lifecos versus their US counterparts
- Acquisition by Industrial Alliance of a wealth manager or mutual fund distributor to replace the loss of the Laurentian Bank distribution channel in late 2014

## Risks

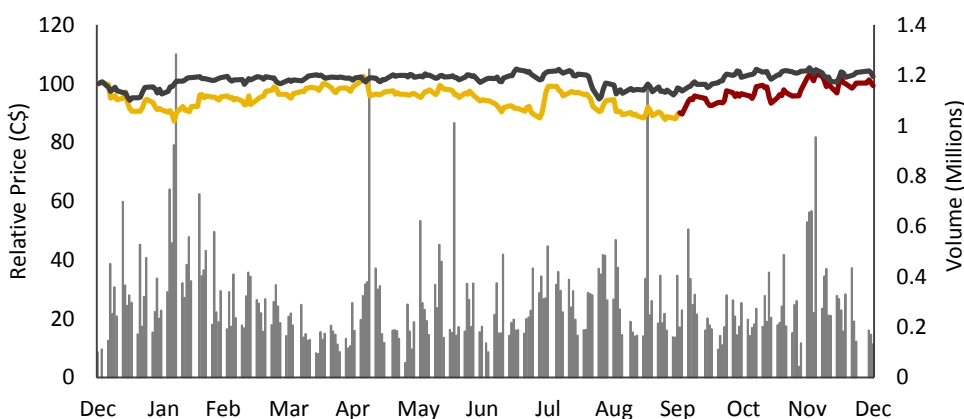
- A further decline in interest rates can eventually lead to negative investment spreads for Canadian insurers
- If the global equity markets were to suffer another downturn (25% drop), Industrial Alliance's net income would decrease by \$77 million (16%)

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$8,419	\$7,736	\$7,494
% Growth		-8%	-3%
EPS	\$3.29	\$4.36	\$4.63
% Growth		33%	6%
Return on Equity	11.43%	11.45%	11.32%
% Growth		0%	-1%
P/E	386.1x	10.2x	9.5x
P/B	1.2x	1.5x	1.3x

## Normalized Stock Price and Sector Benchmark Performance



## Position Snapshot

Average Cost	\$40.01
# of Shares	2,912
Value Invested	\$128,507
Portfolio Weight	4.50%
2015 HPR	10.3%
HP Benchmark Return	4.2%
Excess Return	6.1%

Benchmark: 40% U.S. Financials index (IYF), 60% S&P/TSX Capped Financials Index (XFN).

## Investment Thesis

### 1. What is the market missing? Canadian accounting policies

- Despite stronger business fundamentals, Canadian lifecos trade roughly in-line with their U.S counterparts. In our view, the market is not properly incorporating the difference in accounting standards between the two countries. Under IFRS, Canadian life insurers are required to change their reserves set aside each quarter. Conversely, under GAAP, US life insurers are required to do so infrequently. Given that we are currently in a low interest rate environment, Canadian Lifecos have had to display large reserves, whereas U.S Lifecos are not bound by the same accounting standards to do so. We expect Canadian Lifecos will benefit from a multiple expansion once accounting standards between the two countries converge, upon US life insurers' adoption of IFRS in 2018.

### 2. Market overreaction to one-time headline event

- In Q2 2014, Industrial Alliance lost Laurentian Bank as one of their mutual fund distributors after the expiration of their ten-year contract. Not surprisingly, the stock sold-off on the news. We believe, however, that the 15% drop following the announcement was overdone. In particular, we believe that Industrial Alliance can mitigate the loss by making a strategic acquisition in the wealth management sector, in addition to the growth in their other business segments.

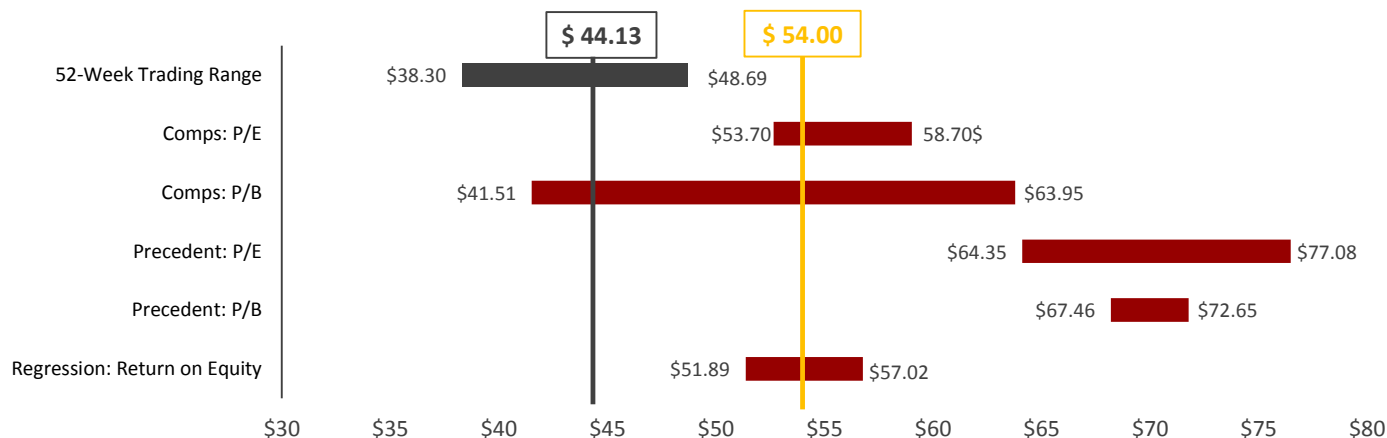
### 3. Industrial Alliance is trading at an unwarranted discount despite stronger business fundamentals

- Significantly discounted on a P/B and P/E basis despite a higher than average ROE and conservative business model, where they hold more investment grade bonds and conservative assets than any other Canadian life insurers

## Analysis of Performance

After initiating our position in early October 2015 at an average price of \$40.01, Industrial Alliance's share price rose to \$44.13 by year end, representing a 10% return in just two months. This appreciation was due to two main factors: a strong Q3 earnings report, and positive investor sentiment following several strategic acquisitions. The earnings report confirmed that Industrial Alliance's performance had not suffered despite the low interest rate environment in Canada, where they continue to generate a strong return on equity. The stock continued to rise in late November, after IAG acquired a mutual fund dealer, a securities brokerage firm, and an insurance agency in the span of one week. Indeed, we had predicted these moves in our original investment thesis, where we felt the market had overreacted to the loss of Laurentian Bank as their mutual fund dealer.

## Valuation Summary



# West End Indiana Bancshares, Inc. (OTCMKTS: WEIN)

## Company Overview

- West End Indiana Bancshares, Inc. was incorporated in June 2011 for the purpose of becoming the savings and loan holding company for West End Bank
- West End Bank, S.B. is an Indiana-chartered savings bank founded in 1894 and headquartered in Richmond, Indiana
- The company provides various financial products and services to individuals, families, and businesses in Indiana.

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$23.15
S/O (mm)	1.1
<b>Market Cap.</b>	<b>\$25.5</b>
+ Total Debt	\$29
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$13
<b>Enterprise Value</b>	<b>\$41.5</b>
Beta (1-Year)	0.16
Dividend Yield	1.1%
52-Week High	\$23.15
52-Week Low	\$19.76

## Catalysts

- West End Bank represents a strong acquisition target, as banks in the Midwest region have seen a plentitude of M&A activity in recent years
- Since going public, an analyst has yet to cover West End; an increase in exposure can lead to an appreciation in their share price

## Risks

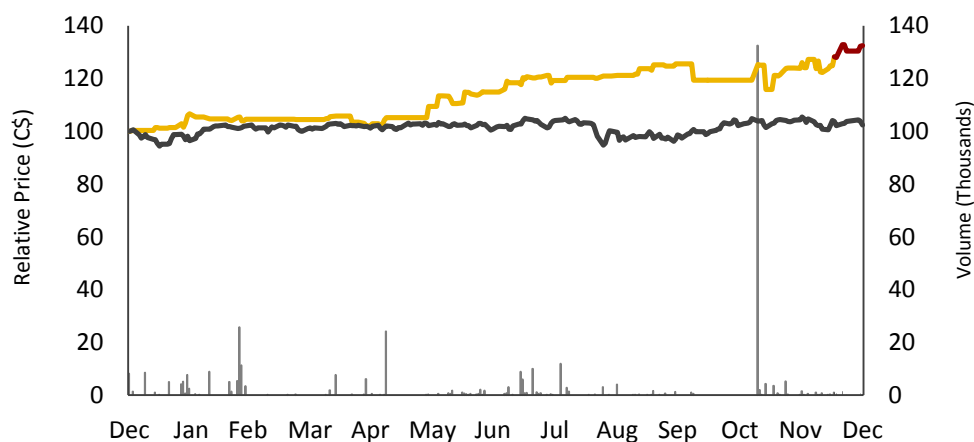
- Given that West End operates in small towns, a decrease in the number of residents can significantly hinder the company's growth prospect
- If more banks were to open in these towns, resulting in increasing competitive pressure, West End could experience a net outflow in deposits

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$11	\$16	\$17
% Growth		41%	10%
EPS	\$1.42	\$1.31	\$1.63
% Growth		-8%	24%
Return on Equity	5.60%	5.10%	5.90%
% Growth		-9%	16%
P/E	16.3x	17.7x	14.2x
P/B	0.9x	0.8x	0.8x

## Normalized Stock Price and Sector Benchmark Performance



## Position Snapshot

Average Cost	\$31.02
# of Shares	1,900
Value Invested	\$61,100
Portfolio Weight	2.14%
2015 HPR	3.3%
HP Benchmark Return	-1.3%
Excess Return	4.6%

Benchmark: 40% U.S. Financials index (IYF), 60% S&P/TSX Capped Financials Index (XFN).

# West End Indiana Bancshares, Inc. (OTCMKTS: WEIN)

## Investment Thesis

### 1. Significant Improvement in Operating Metrics Driven By Strong Management

- Since 2012, West End has improved their margins, operational efficiency, and return to shareholders. This can be seen in various metrics, including the growth in their net interest margin, return on equity, and deposit growth
- Management has shown their ability to execute long-term action plans. Implemented in 2004, management has successfully diversified into a more community bank-like institution with broadened base of financial products and services

### 2. Upside Potential Driven by Oligopolistic Position and “Soft Skills”

- Market and customer knowledge remain a key competitive advantage and barrier to entry
- West End maintains significant market share in both Wayne (16%) and Union (29%) County

### 3. Ideal Acquisition Target With Strong Precedent For M&A

- Since 1993, approximately 62% of companies that converged to full stock ownership have been acquired by or merged with other institutions
- The average P/B multiple of an acquisition target possessing the same qualifications of WEIN ranges from 1.1x-1.3x, and West End currently trades at a 0.9x multiple

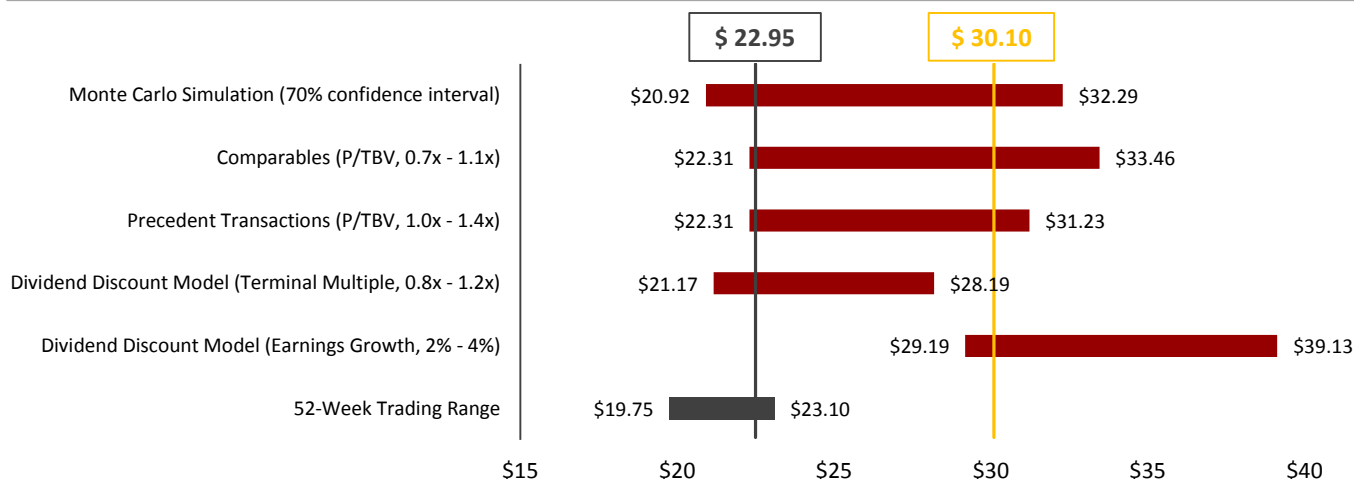
### 4. Valuation Yields Significant Upside At Current Price

- Company is cheap on a P/TBV basis compared to peers in all size and geographic segments
- Valuation model suggests an asymmetric risk-return profile

## Analysis of Performance

Given that DCM initiated this position in late December, we are unable to provide much detail on West End’s performance. With a market cap of just over \$25 million, in addition to minimal daily trading volume, West End’s share price will most likely remain constant from one week to another and we do not see an immediate realization in our investment thesis. We do, however, remain confident in WEIN’s ability to generate returns to our fund. Our thesis is expected to materialize over the course of the next few years, with the ultimate goal of being acquired by a larger competitor, or an increase in analyst coverage. In the interim, we remain satisfied in holding a business with strong fundamentals.

## Valuation Summary



# New York REIT (NYSE: NYRT)

## Company Overview

- Originally formed as a non-trading REIT in 2010, New York REIT is a newly public REIT (IPO in April 2014) that is geographically focused on the New York City metropolitan area
- The company is heavily focused on the Manhattan office space, with over 80% of their portfolio consisting of office buildings, and of that, 96% being based in Manhattan
- NYRT is focused on acquiring commercial real estate, as well as acquiring properties or making other real estate investments that relate to office, retail, and other divisions in Manhattan.

## Financial Summary

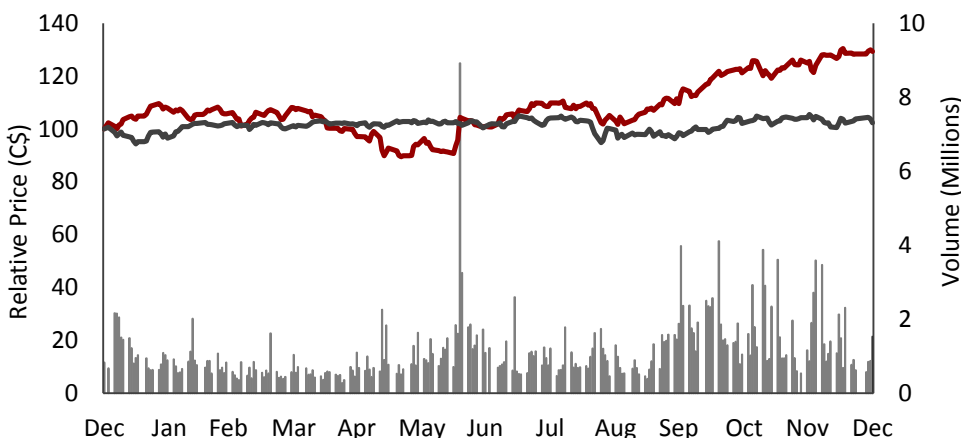
### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$11.50
S/O (mm)	162.5
<b>Market Cap.</b>	<b>\$1,869.0</b>
+ Total Debt	\$876
+ Minority Interest	\$51
+ Preferred Shares	\$0
- Cash	\$20
<b>Enterprise Value</b>	<b>\$2,775.4</b>

Beta (1-Year)	0.51
Dividend Yield	4.3%
52-Week High	\$11.76
52-Week Low	\$8.90

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Financials index (IYF), 60% S&P/TSX Capped Financials Index (XFN).

## Catalysts

- A merger or acquisition by a larger REIT seems plausible, given that NYRT has a very high quality portfolio within Manhattan
- An increase in pressure from activist investors should spur change by adding independent advisors to the company's board of directors

## Risks

- Given NYRT's high concentration of assets in the New York City metropolitan area, the company remains susceptible to falling rent prices in that geographic location
- NYRT's parent company, American Realty Capital ("ARC") established a new non-traded REIT almost identical to NYRT following the success of NYRT's IPO, which may compete on bids for possible property acquisitions given their similar strategies

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$177	\$171	\$212
% Growth		-4%	24%
FFOPS	\$0.465	\$0.428	\$0.380
% Margin		41%	29%
AFFO	\$0.480	\$0.410	\$0.327
% Growth		-15%	-20%
P/FFO	24.7x	26.9x	30.3x
P/AFFO	24.0x	28.0x	35.2x

## Position Snapshot

Average Cost	\$12.53
# of Shares	9,300
Value Invested	\$148,564
Portfolio Weight	5.21%
2015 HPR	29.3%
HP Benchmark Return	2.3%
Excess Return	27.0%

# New York REIT (NYSE: NYRT)

## Investment Thesis

### 1. Quality Lease Portfolio & Experienced Management

- NYRT has the highest direct exposure to Manhattan of any public REIT. We believe that Manhattan real estate is attractively priced, as REITs in this city have historically been insulated from a change in interest rates. An increase in rates should not drastically dampen the value of their assets.
- The credit worthiness of NYRT's tenants remains high, with no near-term lease expirations or debt maturities.

### 2. Significant Room For Growth

- Internal growth project at ~15% over 2016, and ~5% long-term
- External growth opportunities include concrete M&A alternatives and the Worldwide Plaza option.

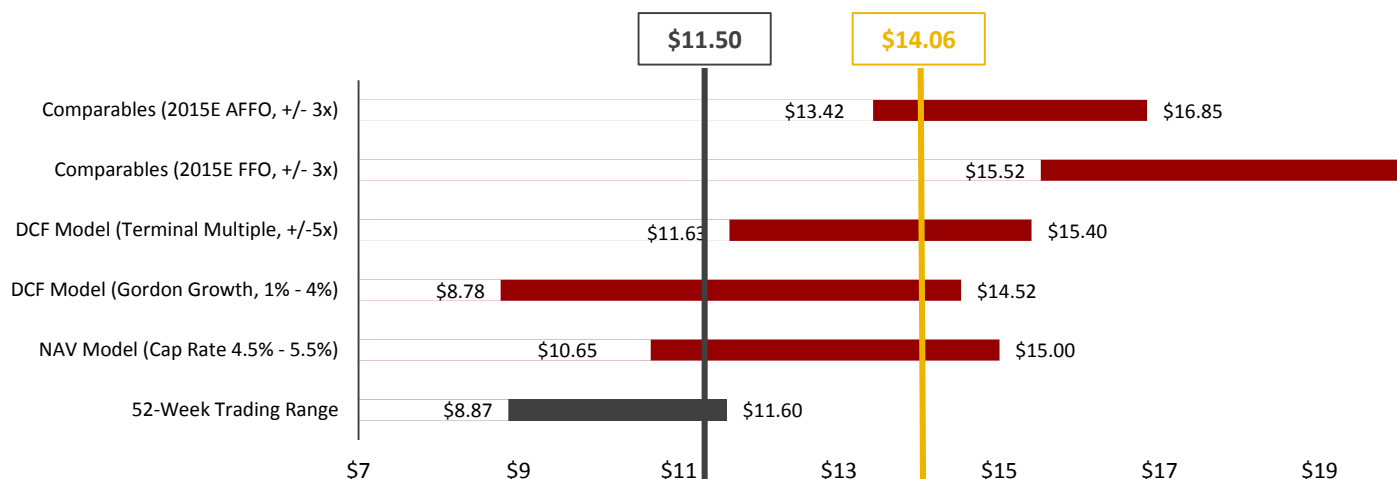
### 3. Attractive Valuation With Low Downside Risk

- NYRT's share price is discounted based on 2016E P/FFO and P/AFFO, NAV, and DCF model
- Under bullish scenarios where pressure from institutions and activist investors push NYRT to take steps to improve its corporate governance and board of director composition, we see a significant reduction in the gap between NYRT's share price and their estimated fair value.
- In addition of being discounted to its peers, NYRT offers a higher than average effective dividend yield

## Analysis of Performance

NYRT was one of DCM's strongest performers this past year, appreciating by 29% in 2015. This represents a 32% outperformance relative to the Dow Jones Industrial and Office REIT index. Demand for office properties in large cities, such as New York, is closely correlated with a country's economic cycle, and NYRT has largely benefited from a strengthening U.S. economy. Moreover, NYRT's performance is attributable to an increase in pressure from activist investors. After Sorin Capital sent an open letter to NYRT management calling for action to close the value gap between their net asset value and share price, the company took initiative in selling off non-core assets and hired a broker to look at potential offers for their properties. The following month, the company also appointed two independent members, Keith Locker and James Nelson, to their board of directors, which eased investor concern regarding NYRT's non-independent board. These initiatives led to a continual growth in NYRT's share price, and in turn, their large outperformance.

## Valuation Summary



# Intesa Sanpaolo (BIT: ISP)

## Company Overview

- Intesa Sanpaolo is the leading Italian bank in retail banking, corporate banking, and wealth management, with respective market shares of 15.1%, 31.9% and 21.7%
- It operates 5,600 branches serving 19.3 million customers
- Intesa is one of the most efficient banks in Europe with a cost-income ratio of 46.5% and has a strong capital position with a Common Equity Ratio at 13.4%
- The bank's operating income relies mostly (i.e. 84%) on stable earnings (i.e. net interest income and net fees and commissions)

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$19.99
S/O (mm)	2643.3
<b>Market Cap.</b>	<b>\$52,825.6</b>
+ Total Debt	\$238,520
+ Minority Interest	\$623
+ Preferred Shares	\$0
- Cash	\$6,362
<b>Enterprise Value</b>	<b>\$285,606.6</b>
<i>Beta (1-Year)</i>	1.55
<i>Dividend Yield</i>	2.5%
<i>52-Week High</i>	\$23.39
<i>52-Week Low</i>	\$16.10

## Catalysts

- Continued and increased support from the European Central Bank to promote investment and economic growth in the European Zone
- Efficient reforms in Italy that will stimulate the economy
- Higher than anticipated dividend increase driven by stronger free cash flows

## Risks

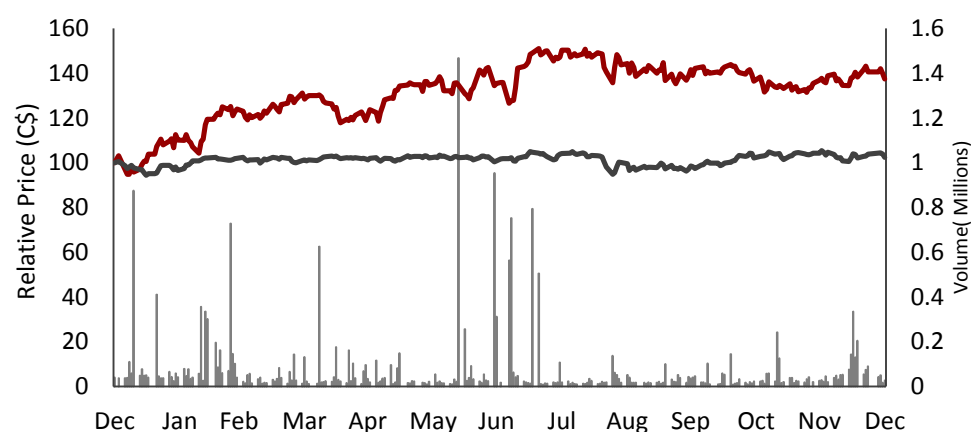
- Further deterioration of the Italian economy could be a significant risk to Intesa as the country has shown low signs of recovery amid low growth, rising unemployment and rising public debt
- Absence of improvements in Intesa's non-performing loan and tier one capital metrics which could lead to a significant deterioration in Intesa's current trading multiples

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$14,295	\$18,267	\$18,986
% Growth		28%	4%
EPS	\$0.21	\$0.23	\$0.27
% Growth		10%	17%
ROE	7.32%	8.22%	9.31%
% Growth		12.30%	13.20%
P/E	14.7x	13.4x	11.4x
P/B	1.08x	1.05x	1.03x

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Financials Index (IYF), 60% S&P/TSX Capped Financials Index (XFN).

## Position Snapshot

Average Cost	\$21.28
# of Shares	2,705
Value Invested	\$75,094
Portfolio Weight	2.63%
2015 HPR	37.4%
HP Benchmark Return	2.3%
Excess Return	35.0%



## Investment Thesis

- 1. End of the “Macro Drag”** The weaker Euro and the renewed commitment by the European Central Bank through its stimulus plan should slowly but surely continue to stimulate the European economy in the short to medium-term. This, together with Mr. Renzi’s continued battle to solve Italy’s economic and political problems with multiple reforms, should put an end to the “macro drag” on Intesa’s share price.
  - The relative valuation of banks in the different European sovereign nations leads us to observe that strong banks in weaker economies are punished with a discount compared to similar banks in strong European economies
  - Even an analysis of Intesa’s credit rating demonstrates that Italy acts as a drag on the bank. This year, Intesa’s credit rating was downgraded by Standard & Poor’s from BBB to BBB- for the sole reason that S&P downgraded Italy’s long-term rating from BBB to BBB- and it needs to keep the bank rating capped at its sovereign rating.
- 2. Strong Fundamentals** The European Central Bank Asset Quality Review acted as a catalyst for the market to give credit to Intesa for its relatively strong capital positions among Italian and European banks
  - Since we initiated the position, Intesa continually improved its efficiency and its capital position, which has repositioned the bank from a third-tier bank to a second-tier European bank.
- 3. Valuation** We continue to foresee an expansion in Intesa’s current trading multiples towards the higher end of mid-tier and high-tier levels of European bank given the company’s strong improvements in non-performing loans, efficiency ratios and tier 1 capital ratios

## Analysis of Performance

We initiated our position in Intesa in March 2014. After a good first year in 2014, our position posted a stellar 25.84% return in 2015, compared to 3.23% for the MSCI European Financials Index. The outperformance was driven by very strong results and improvements on every key metric posted by Intesa for full year 2014 and for H1 2015. The European Central Bank announcement of the expanded asset purchase program at the beginning of the year to stimulate the European Economy also acted as an important catalyst for the stock during the year. Given the strong results and the fulfillment of some parts of the initial investment thesis, DCM sold half of its position in Intesa during the first week of September. We opted for this strategy as a conservative approach to pocket some of the gains we achieved while remaining exposed to what we think is a great exposure in the European banking sector. We remain confident in the position going into 2016.

## Valuation Summary

Company	Ticker	Market Cap	Beta	Div Yield	Tier 1 Capital	P / B	P / TB	P/E	ROE	NPL	Cost / Income
Danske Bank A/S	DANSKE	\$30,641	0.76	2.7%	15.1%	1.28 x	1.38 x	12.20 x	4.1%	3.4%	75.2%
KBC Group NV	KBC	\$27,366	1.54	3.4%	14.4%	1.43 x	1.55 x	11.15 x	16.6%	5.4%	55.4%
Banco Bilbao Vizcaya Argentaria, S.A.	BBVA	\$56,097	1.16	1.0%	11.9%	1.02 x	1.21 x	14.31 x	5.2%	6.6%	62.4%
Deutsche Bank AG	DBK	\$39,621	1.07	2.9%	15.2%	0.47 x	0.59 x	5.77 x	-6.9%	2.0%	88.4%
Lloyds Banking Group plc	LLOY	\$82,741	1.09	1.0%	12.8%	1.06 x	1.16 x	8.89 x	3.6%	2.6%	84.8%
Banco de Sabadell, S.A.	SAB	\$10,914	0.78	0.0%	12.2%	0.84 x	1.01 x	13.96 x	7.9%	9.4%	38.1%
<b>Intesa Sanpaolo S.p.A.</b>	<b>ISP</b>	<b>\$63,985</b>	<b>1.32</b>	<b>2.2%</b>	<b>13.5%</b>	<b>1.12 x</b>	<b>1.33 x</b>	<b>15.54 x</b>	<b>8.9%</b>	<b>9.8%</b>	<b>45.1%</b>
<b>Mean</b>				<b>1.9%</b>	<b>13.6%</b>	<b>1.03 x</b>	<b>1.17 x</b>	<b>11.69 x</b>	<b>5.6%</b>	<b>5.6%</b>	<b>64.2%</b>
<b>Median</b>				<b>2.2%</b>	<b>13.5%</b>	<b>1.06 x</b>	<b>1.21 x</b>	<b>12.20 x</b>	<b>5.2%</b>	<b>5.4%</b>	<b>62.4%</b>
<b>Low</b>				<b>0.0%</b>	<b>11.9%</b>	<b>0.47 x</b>	<b>0.59 x</b>	<b>5.77 x</b>	<b>-6.9%</b>	<b>2.0%</b>	<b>38.1%</b>
<b>High</b>				<b>3.4%</b>	<b>15.2%</b>	<b>1.43 x</b>	<b>1.55 x</b>	<b>15.54 x</b>	<b>16.6%</b>	<b>9.8%</b>	<b>88.4%</b>

# Wells Fargo & Company (NYSE: WFC)

## Company Overview

- Wells Fargo is the largest US bank by market capitalization, and 4th largest by assets (\$1.8 trillion).
- The bank provides banking, insurance, investments, mortgages, and consumer and commercial financial services through 8,700 locations.
- The bank has diversified revenue with the bulk driven by net interest income (54%), brokerage advisory & commissions (11%), deposit service charges (6%), mortgage origination (5%), card fees (5%), and trust and investment management (4%)

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$54.36
S/O (mm)	5107.8
<b>Market Cap.</b>	<b>\$277,660.7</b>
+ Total Debt	\$297,064
+ Minority Interest	\$893
+ Preferred Shares	\$20,852
- Cash	\$289,241
<b>Enterprise Value</b>	<b>\$307,228.7</b>
Beta (1-Year)	0.97
Dividend Yield	3.1%
52-Week High	\$58.52
52-Week Low	\$50.02

## Catalysts

- Improvement in the Net Interest Margin driven by the FED rate increase
- Increasing ability to cross-sell products
- Continued share buyback and dividend increases

## Risks

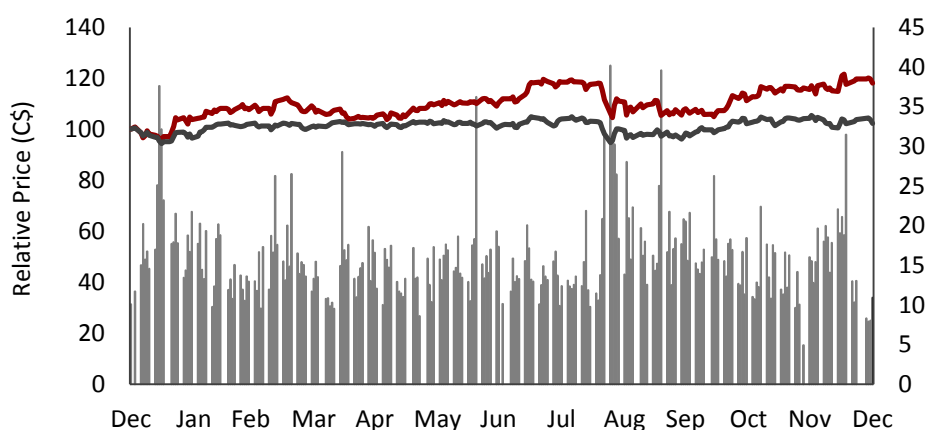
- Loss of the commercial banking competitive advantage to J.P. Morgan, Citigroup and Bank of America
- Increasing default rates on loan portfolio
- Overly aggressive acquisitions of loan portfolios
- Increasing importance of the Investment Banking division

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$83,615	\$90,044	\$95,687
% Growth		8%	6%
ROE	12.86%	12.17%	12.42%
% Margin		-5%	2%
EPS	\$3.99	\$4.35	\$4.75
% Growth		9%	9%
P/B	1.63x	1.54x	1.45x
P/E	13.6x	12.5x	11.5x
P/CFPS	12.4x	12.4x	11.5x

## Normalized Stock Price and Sector Benchmark Performance



## Position Snapshot

Average Cost	\$32.50
# of Shares	2,011
Value Invested	\$151,854
Portfolio Weight	5.32%
2015 HPR	18.1%
HP Benchmark Return	2.3%
Excess Return	15.7%

Benchmark: 40% U.S. Financials index (IYF), 60% S&P/TSX Capped Financials Index (XFN).

# Wells Fargo & Company (NYSE: WFC)

## Investment Thesis

- Wells Fargo is a safe play on the U.S. banking industry** Wells Fargo gets the bulk of its revenue from a stable source of income
  - Revenue from Investment Banking was only 4%, with the main shares of revenue coming from net interest income (54%), brokerage advisory & commissions (11%), deposit service charges (6%), mortgage origination (5%), card fees (5%), and trust and investment management (4%)
- Wells Fargo has a sustainable competitive advantage in the United States banking industry.** The competitive advantage is driven by the low cost of deposits, the ability to cross-sell products, and its sustainable high net interest margin
  - In 2015, Wells Fargo continued to improve its ability to cross-sell products reaching 6.11 for community banking, 7.3 for wholesale banking and 10.55 for the wealth, brokerage and retirement division
  - Wells Fargo was able to maintain one of the highest net interest margins (2.95%) among its peers in 2015
- The United States financial sector provides opportunity**
  - The increase of the Fed Funds rate will provide an opportunity for bigger lenders such as Wells Fargo to increase their net interest margin and therefore drive their bottom line
  - The rate hike of the Fed sent a signal about the state of the U.S. Economy. The employment market, household spending and business fixed investments have improved in 2015. Wells Fargo expects to take advantage of the state of the US economy notably through the organic growth of its loan portfolio. Year-over-year, Wells grew all its loan portfolio: commercial and industrial loan portfolios (10%), core family first mortgage (8%), commercial real estate (10%), automobile (8%), other revolving credit and installment (9%) and credit card (9%).

## Analysis of Performance

2015 was a year driven by macro events. Overall the position was flat for the year, but it was the result of a year defined by 3 distinct parts. After a selloff in January, Wells Fargo was up about 8% at midyear driven by strong financial results, improvement on multiple facets of the US economy and continuous share buybacks. Then, the position lost almost 20% in a matter of days in August which was driven by the Chinese selloff and the panic it caused in the market. Finally, Wells Fargo recovered its loss in the last quarter of the year mainly driven by strong financial results and the implementation of the first Fed funds rate hike in a decade which is a sign of a better era for Wells Fargo's net interest margin. Wells Fargo finished the year with a -0.86% return in-line with the return of -2.00% for the U.S. financial benchmark.

## Valuation Summary

### Big Four U.S. Banks

Company	Ticker	Market Cap	Beta	Div Yield	Tier 1 Capital	P / B	P / TB	P/E	ROE	NPL	Cost / Income
JPMorgan Chase & Co.	JPM	\$209,834	1.64	3.1%	12.0%	0.95 x	1.21 x	9.30 x	10.3%	0.8%	62.3%
Bank of America Corporation	BAC	\$148,274	1.70	1.4%	10.2%	0.63 x	0.92 x	9.42 x	6.6%	0.0%	68.6%
Citigroup Inc.	C	\$123,861	1.95	0.5%	12.0%	0.60 x	0.69 x	7.88 x	8.0%	0.9%	58.1%
Wells Fargo & Company	WFC	\$245,490	0.87	3.1%	11.0%	1.42 x	1.67 x	11.20 x	12.9%	1.2%	57.1%

*"It's far better to buy a wonderful company at a fair price than a fair company at a wonderful price"*  
– Warren Buffet

# Energy Sector

2015 Review & 2016 Outlook

*By Christophe Lussier, Jamie Wilson, and Kendyl Flinn*

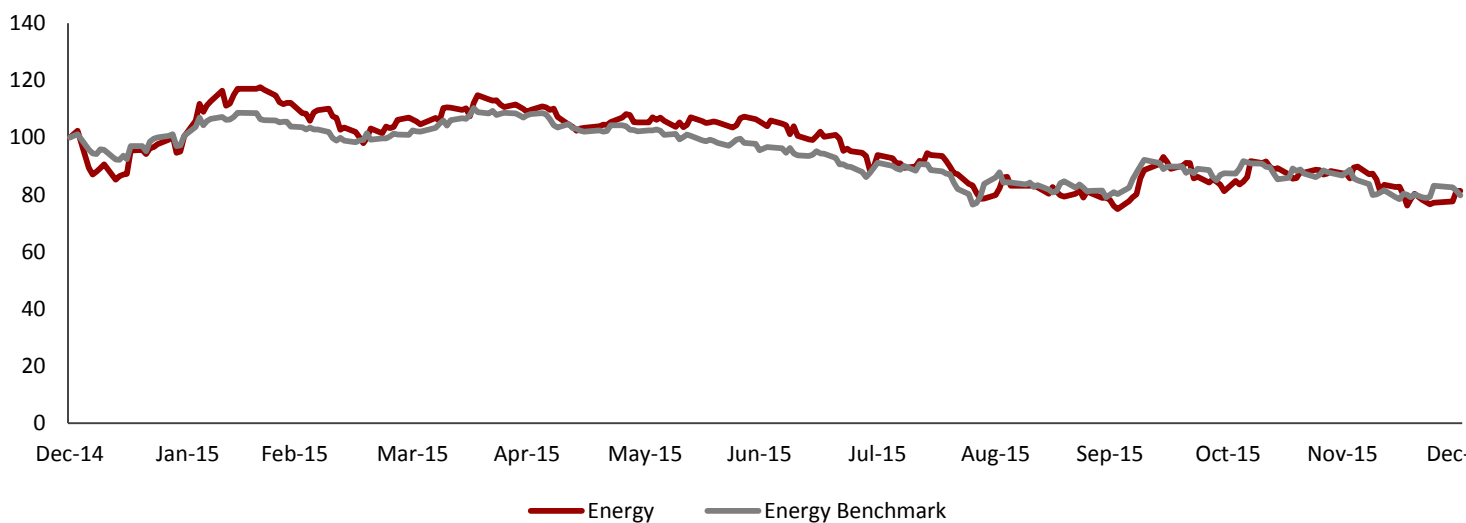


## Overview

Following a disastrous second half of 2014, 2015 has been an even tougher year for oil investors around the world. In Canada, the S&P TSX Capped Energy Index (XEG) returned approximately -28% over the year, while the S&P TSX Index was down by approximately 11%, making Energy one of the worst performing sectors in Canada. Oil's poor performance in 2015, however, was not anticipated by many investors. Indeed, during the first half of the year, the future was looking much brighter for oil, as investors and experts were still bullish on the commodity, expecting prices to pick up in H2 2015. Their expectations seemed to be materializing in early April (after two slumps in late January and mid-March) when the WTI soared back to the high US\$50 range on the back of encouraging declining US inventory levels. Prices stabilized around US\$60 for nearly two months before things went bad with slower than expected growth from China leading the slide in August. On top of this weaker demand for petroleum products, US production kept rising, despite producers' efforts to significantly reduce the number of wells. As well, in December, OPEC stood its ground and refused to cut production. Combine these factors with the United States lifting sanctions on Iran, and you have the perfect cocktail for sinking oil prices.

In 2015, DCM was not spared by the global market sell-off in the oil & gas sector. The DCM Energy Sector's performance closely tracked its benchmark for most of the year, returning -19.7%, representing a slight 30bp outperformance relative to the blended 60% Canada/40% US energy sector benchmark. *Figure 1* below shows the sector's annual performance compared to our benchmark. This year's performance has been a story of large losers and winners, with MEG Energy's -59% return leading the slump. Parex Resources and Marathon Petroleum Company, however, performed exceptionally well given the reality of the oil & gas sector, with both companies ending the year in the green at 34% and 30.8% respectively. Unfortunately, their performance was not enough to offset MEG Energy's decline, as well as Pulse Seismic's -24% decline for the year.

**Figure 1: Performance Analysis**



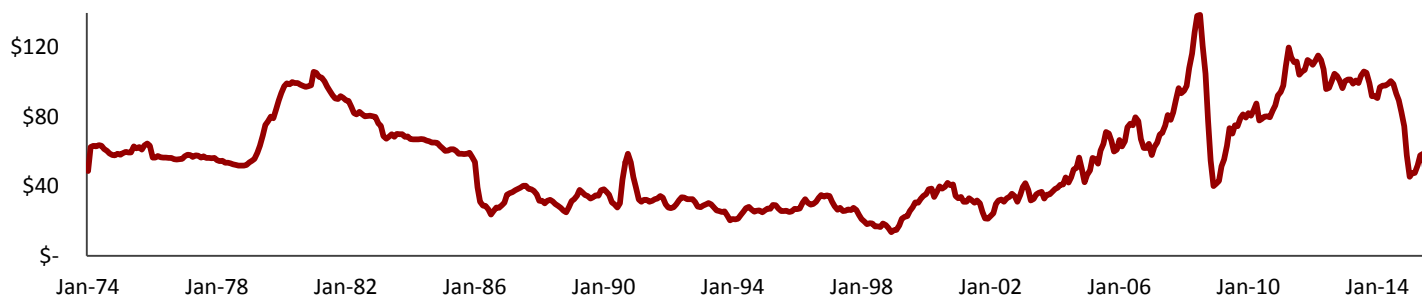
Benchmark: 40% XLE US Equity & 60% XEG CN Equity

Over the course of the year, WTI prices fell 29.7%, and are now back to their 2003 levels, ending the year in the US\$35-\$40 range. OPEC's decision, led by Saudi Arabia, in early December to refuse to curb production, as well as its failure to agree to a production ceiling, have sent oil prices tumbling. It seems that, even one year later, we are still facing the same dead-end with OPEC and the US choosing to play a game of "who blinks first". With a full year of depressed oil prices already behind us, it seems increasingly likely that 2016 will mark the end of the oil & gas industry as we know it. Producers and investors alike should prepare for a "lower for longer" reality.

### What's Next?

The recent fall in oil prices has without a doubt reached historical proportions and will leave a scar on the energy industry for decades to come; likely through aggressive capital expenditure cuts in the US and Canada. However, even if this is not to be a usual oil-price decline, it is not oil's first appearance in the 50% sell-off club either. As Mark Twain once said: "History doesn't repeat itself, but it rhymes". With this in mind, we believe it is important to look at the past before trying to predict what's to come. *Figure 2* illustrates the fluctuations in WTI prices from 1974 to 2015.

**Figure 2: Historical WTI Prices (US\$/bbl)**



From *Figure 2*, it is important to highlight two significant crashes and the events that followed. The most recent decline in oil prices took place in 2008, largely due to decreases in demand and negative economic sentiment after the financial crisis, rather than supply-side issues. Unlike today, economic indicators were still net positive for oil in 2008. Demand from China was strong, OPEC was still in full control of oil prices, and the United States had not yet realized the full potential of fracking and their land's abundant resources. Helped by these factors, as well as political tensions in the Middle East, oil prices soared back towards the US\$100 mark rapidly in a V-shaped recovery. Another, and more representative crash took place in 1986. As opposed to 2008, in 1986 crude prices fell because of growing non-OPEC supply, slower demand growth for petroleum products, and OPEC's decision to keep production constant. Sound familiar? What followed was a ten year period of low oil prices, otherwise known as the dreaded L-shaped recovery.

Looking ahead, we expect the recovery in oil prices to be much more similar to 1986 than 2008. The current low oil price environment is mainly a supply-side issue, and will not be resolved by anything other than a supply-side adjustment. While we believe that lower prices may be here to stay, we are by no means bearish on the fundamentals of the oil industry; IEA data shows global oil demand projected to grow at 1.3% in 2016, entirely driven by 2.5% expected demand growth from Asia.

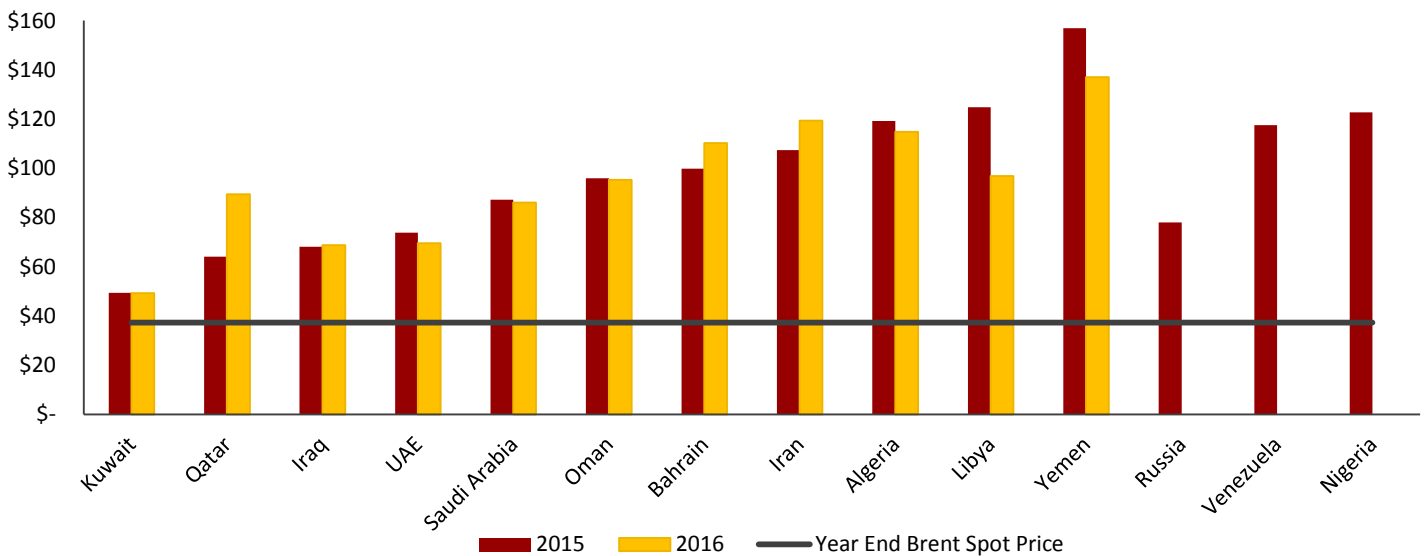
Historically, oil price trends have been dictated by major geopolitical disruptions rather than relatively gradual fluctuations of supply and demand. *Figure 2* shows periods of stable prices punctuated by sharp rises due to the Iranian revolution of 1980, Operation Desert Storm in 1990, the US led invasion of Iraq in 2004, and the Arab Spring of 2011.

We believe that oil prices will rise gently from the current low-levels, but we shouldn't expect a major rebound to levels above US\$70-80 without a significant geopolitical interruption.

## Middle Eastern Perspective

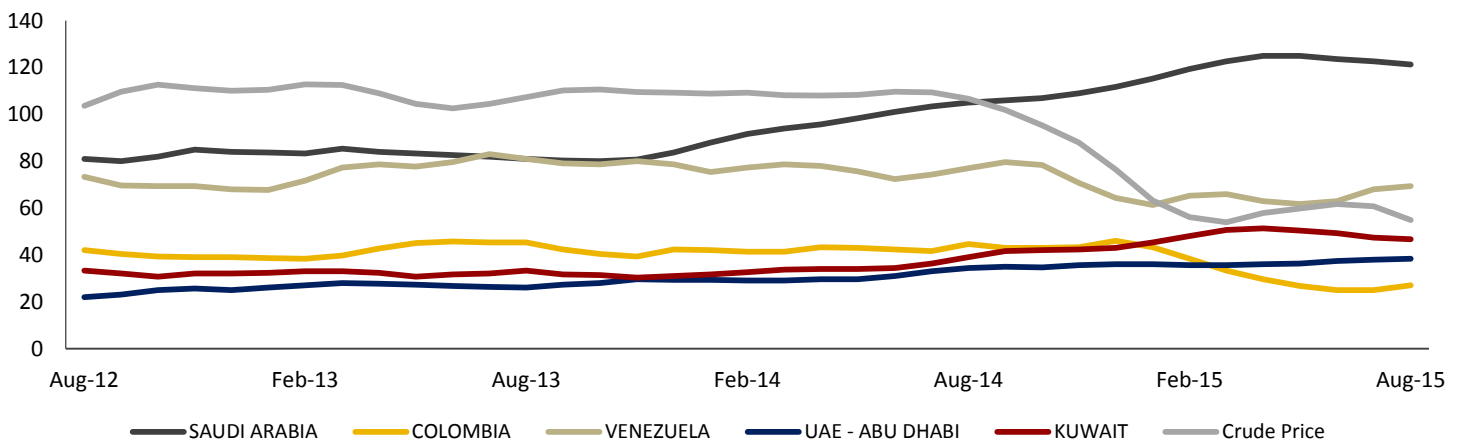
In 2015, many expected OPEC, particularly Saudi Arabia, to cut production and bring prices back in line with the levels required to balance fiscal budgets (*Figure 3*). There was also speculation that US production would fall significantly as shale producers took on the role of global 'swing producer'. As we predicted, the first belief was too optimistic. The OPEC meeting of December 4<sup>th</sup> ended in a decision not to cut production, thus signalling the end of the oil market oligopoly. Global oil markets now better resemble a perfectly competitive state as each nation (or in the case of North America, individual company) produces as much as they can. This is primarily because producing countries have been unsuccessful in finding a supply control agreement.

**Figure 3: Breakeven Price for a Balanced Fiscal Budget**



We have also seen a willingness of most producers to keep increasing production, particularly in the Middle East. This is shown below in *Figure 4*, which illustrates that producers with the political stability to increase rig count (Saudi Arabia, Algeria, UAE, and Kuwait) have consistently done. In fact, they have actually increased the growth rate since the price decline started in 2014. This trend has been led by Saudi Arabia, where the average annual rig count increased by 52% from H2 2012 to H2 2015 reaching a record high in 2015.

**Figure 4: Historical Rig Count**



Source: Baker Hughes, EIA.



## Energy Sector

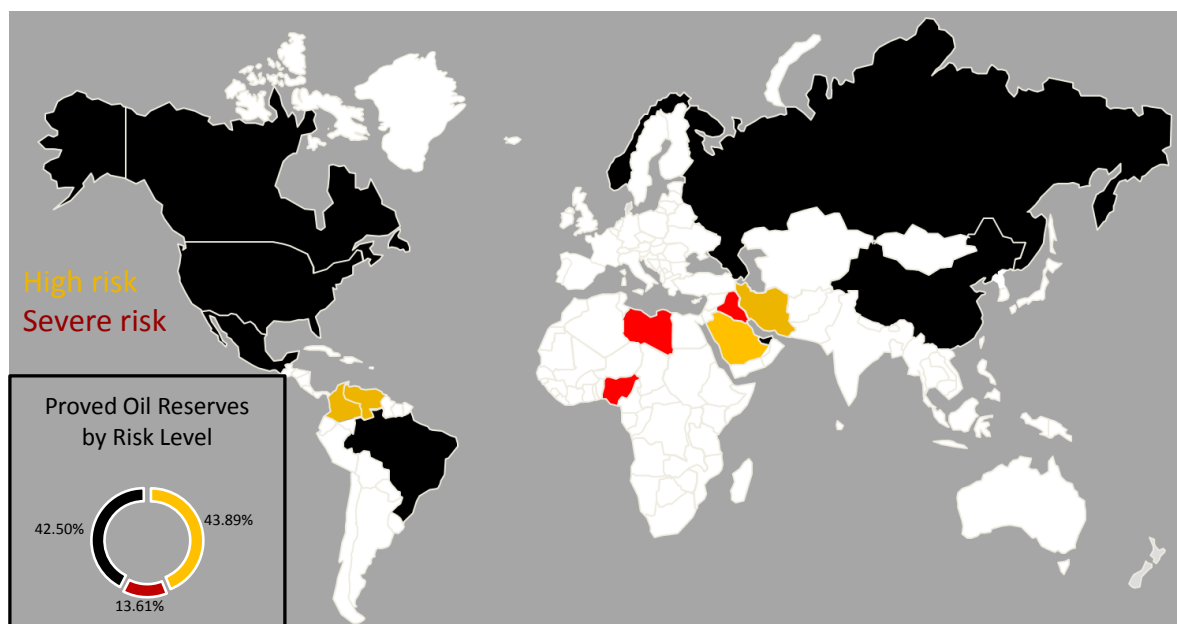
The conflict between Saudi Arabia and Iran has been another leading factor in the oil price decline. The two states have been battling for regional hegemony since the Islamic Revolution in Iran in 1979. Saudi Arabia, desperate to maintain its position as the leading political power in the Middle East, has been threatened by the return of Iran to the international energy markets in 2016. Also, Iran's increasingly vocal support for the Assad regime in Syria, and simultaneous threat of Islamic State and their challenge of Saudi Wahhabism as the dominant conservative Islamic power in the Middle East, has hurt the country's relationship with Saudi Arabia. The result has been a Saudi reluctance to give up its position as the largest supplier of crude oil to international markets for fear of losing political influence in Iran. This reluctance is further driven by memories of Saudi politicians such as Energy minister Ali Al-Naimi, President of Saudi Aramco in the 1980s, of the disastrous cut in Saudi oil production in 1986 to prop up global energy markets.

### Breaking Point

We see the rising tensions in the Middle East as a potential driver of higher oil prices, in addition to similar issues in other oil-producing areas. As we have seen in *Figure 3*, fiscal budgets in most oil producing countries are coming under serious pressure and politicians have been taking more extreme measures to maintain control of their nations petro-economies.

Focal points such as Venezuela are beginning to emerge as potential tinderboxes for global supply disruptions, as the oil price drop has led to a depreciation of the Bolivar against the US dollar. IMF inflation predictions for 2016 are at 720% for the country, as Venezuela previously relied on oil for 96% of export revenues. The official exchange rate remains at 6.30 VEF/USD, however, unofficial currency exchange websites such as *Dolartoday.com* are quoting rates of up to 900 VEF/USD. President Nicolas Maduro's government has attempted to declare a state of emergency already in 2016 as he struggles to deal with social unrest and hang onto power, having lost national elections in December 2015.

**Figure 5: Political Tensions in Oil-Producing Countries**



*Figure 5* above shows the level of perceived political risk in major oil producing nations and explains our long-term bullish views on oil. The longer prices stay at current depressed levels, the more likely it becomes to see a major supply disruption which could push prices back up.

Source: AON.

## Energy Sector

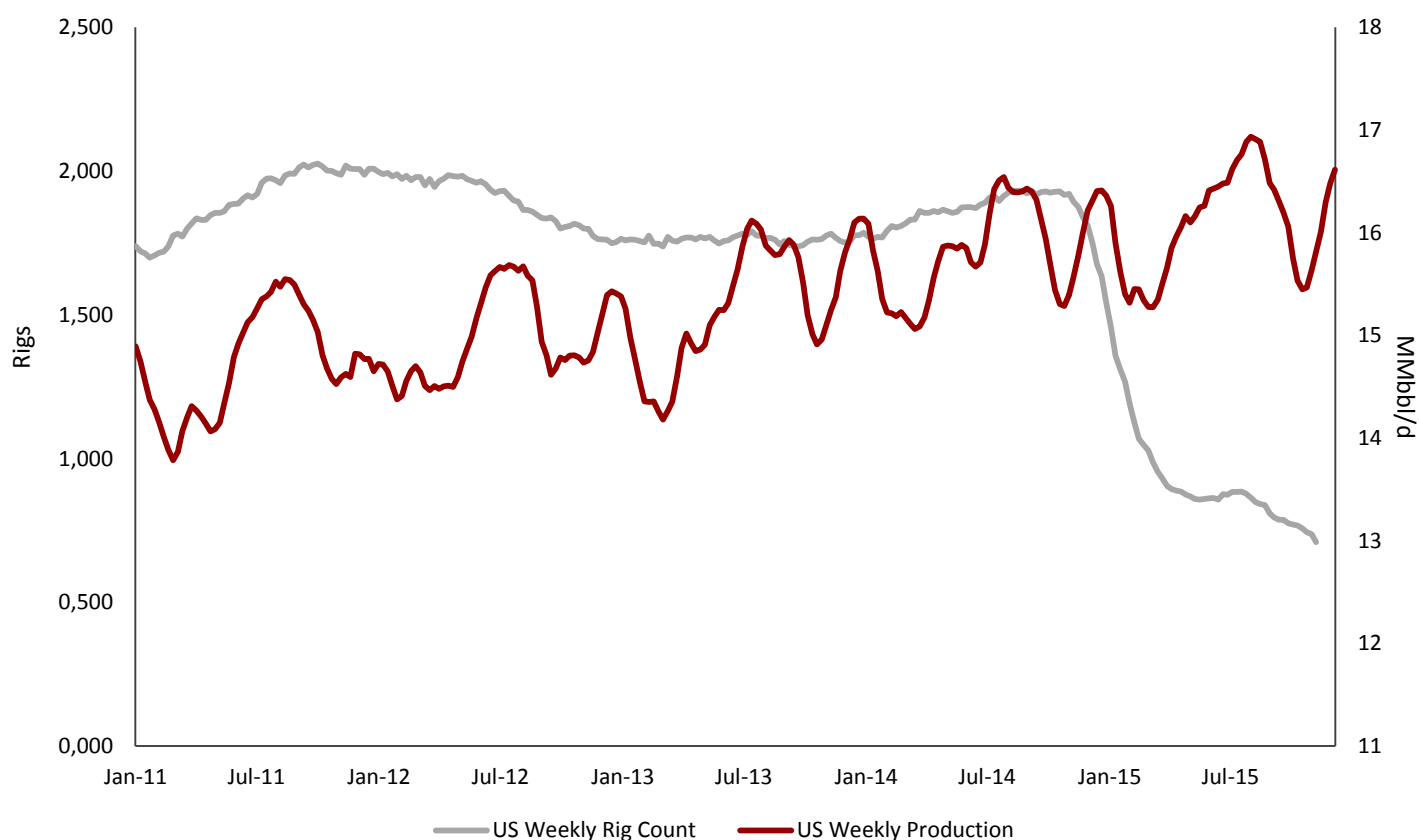
There are a number of oil producing countries that appear to be nearing a potential armed conflict, for example a revolution in Venezuela or the escalation of Saudi Arabia and Iran's proxy war in Yemen. In recent history, we have seen a supply disruption very similar in nature; in 2011, following the deposition of Muammar Al-Qaddafi in Libya, oil production fell dramatically, and four years later the country's production is still 70% lower than its peak level of 1.5 mmboe/d.

### North American Perspective

The effect of the recent price declines on the US shale market has been close to classic Schumpeterian creative destruction. It is clear that many managers miss-calculated breakeven oil prices in the US\$60-70 range, as shale producers have shown themselves to be resilient in the face of lower prices. Corporations have come to exploit their assets and manage their supply chain more efficiently, allowing them to reduce costs significantly and keep afloat despite a sustained low price environment.

Part of the WTI's weak performance in 2015 can be attributed to the US' increasing production despite its falling rig count. *Figure 6* shows US production compared to US well inventory between 2011 and 2015. The phenomenon seen in 2015, known as high-grading, is the result of US producers keeping only their best-performing wells on production and closing less productive ones. We see the reverse event (which we could call "reverse high-grading") as a likely outcome if oil prices rise as companies are waiting for more favourable WTI prices to put the most promising new wells online. For this reason, we expect that any short-term price spikes would be at least partially mitigated by increases in North American production and sales of the current, record-high inventory backlog.

**Figure 6: Historical US Production vs. Rig Count**



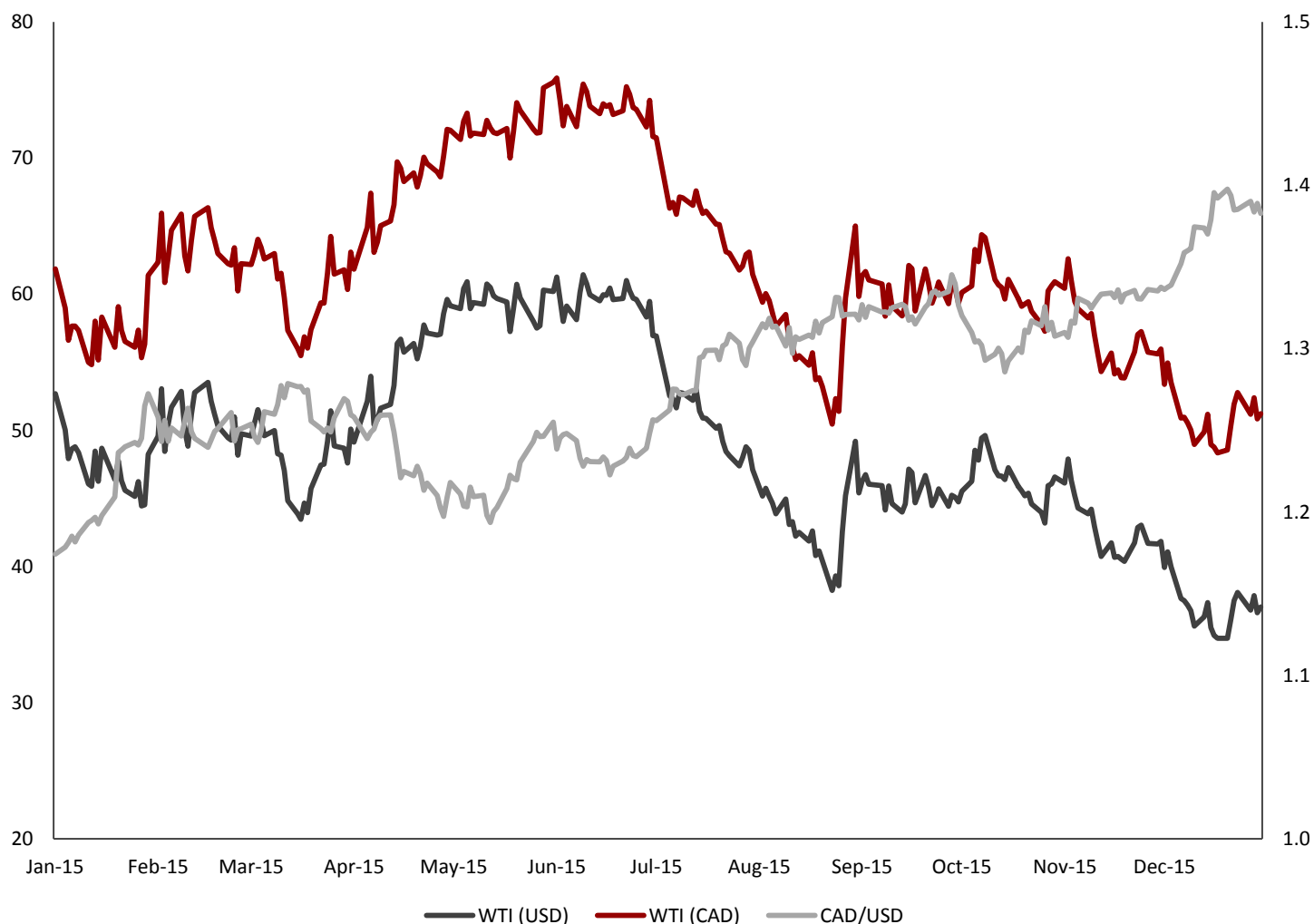
Source: Baker Hughes, EIA.

### What About Canada?

Canadian crude oil and natural gas companies have also taken a solid hit in 2015. Most exploration and production (E&P) companies have taken drastic cost-cutting measures, including layoffs and important budget reductions. As a result, the Canadian Association of Petroleum Producers (CAPP) has significantly lowered its Canadian long-term production outlook (from 6.4 mmbbl/d to 5.3 mmbbl/d by 2030). This lower estimate is mainly due to lower production growth from oil sands, which represent approximately 80% of Canadian reserves. In the short to medium term, however, many oil sands projects are unlikely to be shut-down due to the industry's high sunk cap-ex costs, relatively low operating costs, and long production life. In the current oil price environment, the market has overly punished the industry as a whole, creating opportunities for investors who can identify high-quality operators.

Canadian producers have gained some respite from the weakness of the Canadian dollar since most of their costs are denominated in CAD while revenues are in USD. This allowed companies to capture a higher realized oil price than competitors south of the border. Figure 4 (below) shows WTI price fluctuations in both USD and CAD as well as the CAD/USD exchange over 2015.

**Figure 7: Historical WTI (\$/bbl) and CAD/USD Exchange Rate**



Source: Bloomberg as at Dec. 31, 2015.

# Energy Sector

Holdings Review



# MEG Energy Corp. (TSX: MEG)

## Company Overview

- MEG Energy is an exploration and production company focused on sustainable in-situ oil sands development in the Athabasca region of Alberta, Canada
- The company currently has 3 bn barrels of 2P bitumen reserves and achieved record production of 82,768 boe/d in Q3 2015
- MEG uses stream-assisted-gravity-drainage (SAGD) extraction methods and innovative eMSAGP technology at its Christina Lake production site
- MEG's budget going into 2016 is \$328mm with 20% dedicated to growth capital

## Catalysts

- Long lifetime of projects allows lower capital expenditure requirements during the supply glut
- Able to sell non-core assets and its position in Access Pipeline in order to stay liquid despite the low price environment
- Marketing via the Flanagan Seaway Pipeline, which gives MEG access to PADD III and better pricing

## Risks

- MEG is heavily indebted, debt is 77% of enterprise value, with maturity in 2020
- Natural gas is a key input in the SAGD extraction method MEG utilizes, so increased prices would increase input costs for the company

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

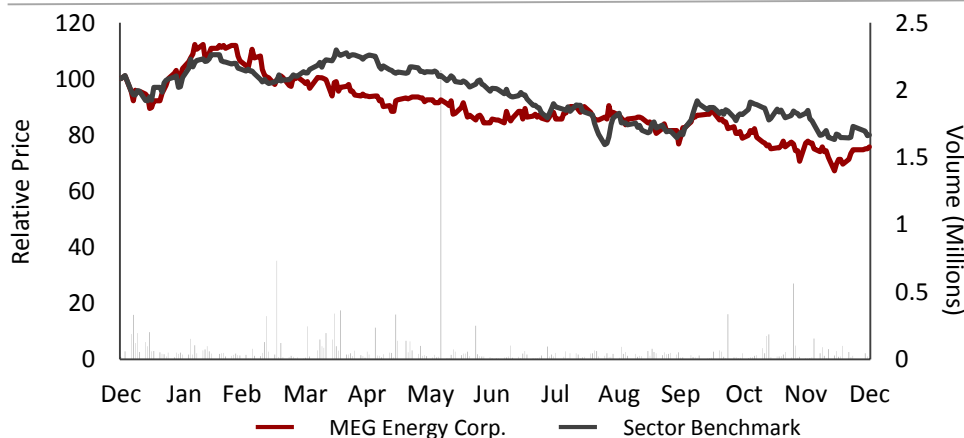
Share Price	\$8.02
S/O (mm)	225
<b>Market Cap.</b>	<b>\$1,804.0</b>
+ Total Debt	\$5,074
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$351
<b>Enterprise Value</b>	<b>\$6,526.8</b>
Beta (1-Year)	3.26
Dividend Yield	--
52-Week High	\$24.90
52-Week Low	\$7.56

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$2,096	\$2,032	\$2,302
% Growth		-3%	13%
EBITDA	\$411	\$529	\$863
% Margin		26%	37%
EPS	-\$2.94	-\$0.86	\$0.16
% Growth		-71%	-119%
NAV/Share	\$12.21		
EV/2P	4.4x		
EV/2P + 2C	1.2x		

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Energy index (XLE) in CAD, 60% S&P/TSX Capped Energy Index (XEG).

## Position Snapshot

Average Cost	\$33.15
# of Shares	5,195
Value Invested	\$41,664
Portfolio Weight	1.46%
2015 HPR	-59.0%
HP Benchmark Return	-20.0%
Excess Return	(39.0%)

All figures in CAD

# MEG Energy Corp. (TSX: MEG)

## Investment Thesis

- 1. Overblown sell-off following the broad-based Energy sector decline:** The -59% drop in 2015 is representative of the company's 79.2% correlation to oil and lack of hedging during the price decline; however, the underlying business and assets are strong
  - MEG was able to achieve a 12% increase in production in 2015 and has projected to continue with 2-7% production growth through 2017
  - On an asset basis, MEG trades at an EV/2P+2C of 0.96x which is low for the industry. They also have a brownfield expansion plan outlined for Christina Lake once (read: if) oil prices rise to the \$60-70/bbl range
  - While certainly a concern, the market is overstating MEG's leverage risk (details below)
- 2. MEG's "hub and spoke" marketing strategy and strategic initiatives:** MEG has successfully created an efficient production and transportation system. The company recently completed Phase 2B at the Christina Lake site which implemented the proprietary RISER technology that harnesses excess steam released in drilling to reuse in SAGD extraction. In 2015, the company also began using the Flanagan-Seaway Pipeline to bring the heavy oil down to PADD III. This gave MEG access to the best refineries and world market pricing
- 3. MEG's low cost advantage:** MEG's cost advantage improved further in 2015 with operating costs at \$9.95, and a steam-oil ratio (SOR) of 2.5x in Q3 2015. This is a strong competitive advantage for the company, putting them in the top quartile of oil sands companies, in case of sustained low oil prices

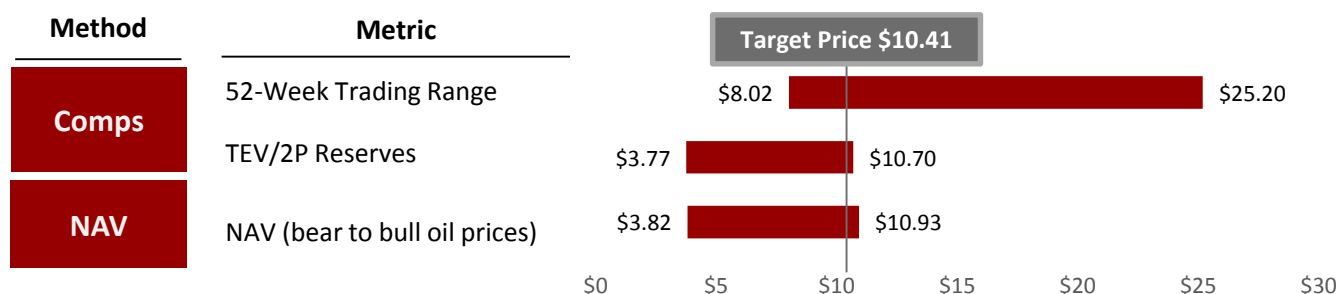
## Analysis of Performance

Since MEG is a pure play oil sands company with a high correlation to oil and no hedging, the stock price has fallen steadily with WTI, down 59% in 2015. However, the company is actively working to keep production up and still has strong liquidity. The company had a record setting third quarter, producing 82,768 bpd of bitumen, and has projections for 2016 between 80,000 to 83,000 per day. This would represent an approximated 2% increase in production YoY. Additionally, in the fourth quarter of 2015, the company sold \$110 million worth of non-core assets to improve the cash position and pay down debt. This signifies that the management team knows the reality of the company's situation with the drop in oil and is actively working to maintain capital. The main risk with regards to the company is its high level of debt, sitting at 77% of MEG's enterprise value.

## Expectations for 2016

- **Sell 50% stake in Access Pipeline**
  - **Achieve 2-7% production growth**
  - **Uphold low operating costs**
- MEG needs to continue selling non-core assets to pay down debt. There is no debt maturing until 2020, but in the case of a sustained low price environment, the company's balance sheet will deteriorate quickly or it will be forced to access the revolver. Also, if MEG can sell its 50% stake in the Access Pipeline, at a lucrative price (approx. \$1.5-2B), it will provide substantial cash flow and create a healthier balance sheet.

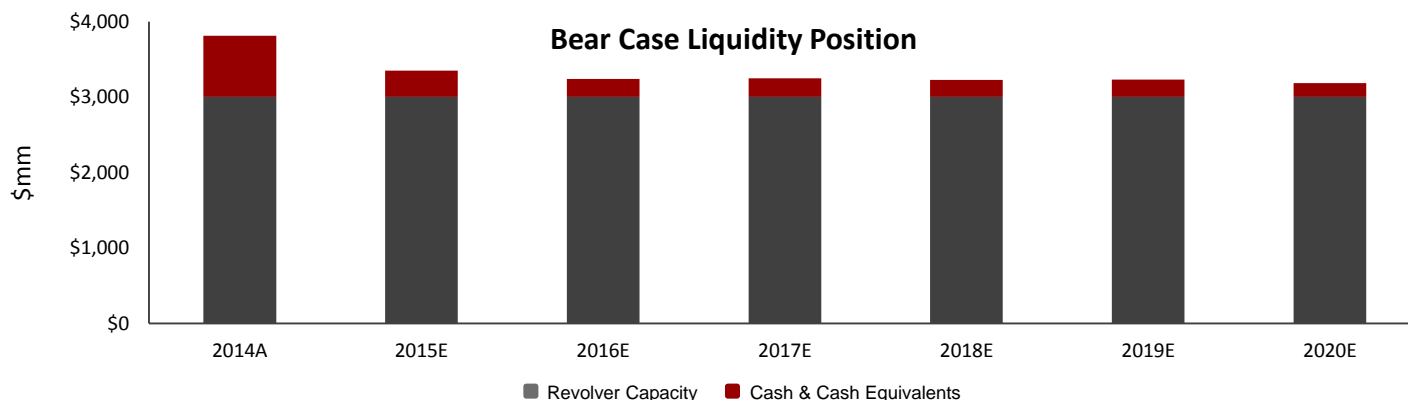
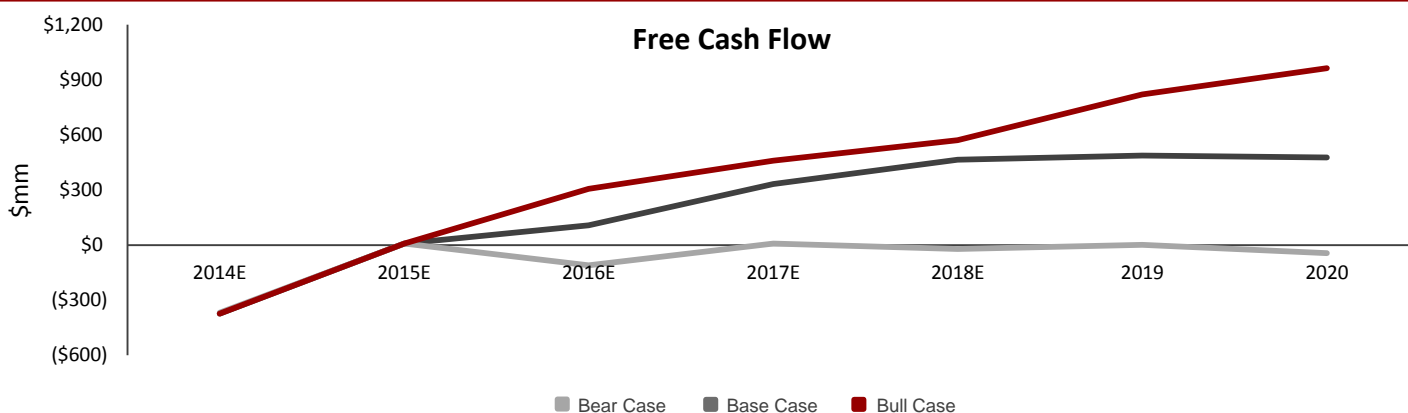
## Valuation Summary



## Leverage & Downside Analysis

- MEG still maintains substantial liquidity through the untouched credit facility, cash on hand, and sale of non-core assets. Under the Bear case scenario - oil prices at \$40/bbl in the long-term - free cash flow is always negative (see line graph), but given MEG's extremely low sustaining Capex budget and cash position, the company is able to pay interest without drawing on its revolver facility
- MEG maintains a healthy Interest Coverage ratio (2.4-4.0x) under our Base and Bull case. In our Bear case, the ratio drops below to 0.84x, but MEG's liquid assets allows it to pay the remaining interest expense (post-OCF) without touching its bank facilities
- MEG's breakeven oil price comes in at \$48-49/bbl WTI according to an internal survey by TD, but its upfront capital investment and technology give it room to continue producing at virtually any price
- MEG's recent reduction in capex budget (from \$1.2B to \$170mm) provides flexibility and an ability to weather the storm with minimal impact on production and continued growth
- We see MEG initiating more cap-ex for brownfield expansion and improvement projects to achieve previous growth initiatives if oil prices recover in the \$60-\$70/bbl range

	2014A	2015A	2016E	2017E	2018E	2019E
Base Case – Street	\$93.60	\$48.70	\$46.82	\$56.00	\$63.25	\$65.00
Bear Case	\$93.60	\$48.70	\$38.00	\$43.00	\$48.00	\$50.00
Bull Case	\$93.60	\$48.70	\$60.00	\$65.00	\$70.00	\$80.00



\*As the objective of our analysis is to measure leverage in extreme scenarios (and not growth), we maintain production constant after 2016.

# Pulse Seismic Inc. (TSX: PSD)

## Company Overview

- Pulse Seismic is an oil and gas services company that acquires, markets, and licenses 2D and 3D seismic data primarily to the Western Canadian energy sector
- Pulse Seismic controls the second largest seismic data library in Canada. It currently stores 28,400 net km<sup>2</sup> of 3D data and 340,000 km<sup>2</sup> of 2D data
- Pulse Seismic owns data across the Western Canada Sedimentary Basin, in addition to the Northwest United States
- The replacement value of Pulse's library is estimated at over \$2 bn

## Catalysts

- LNG project approvals could spur natural gas exploration in Canada
- Higher natural gas prices, to levels seen in 2013
- M&A activities in the E&P space picking up
  - Benefiting Pulse due to the lack of transferability of data in deals

## Risks

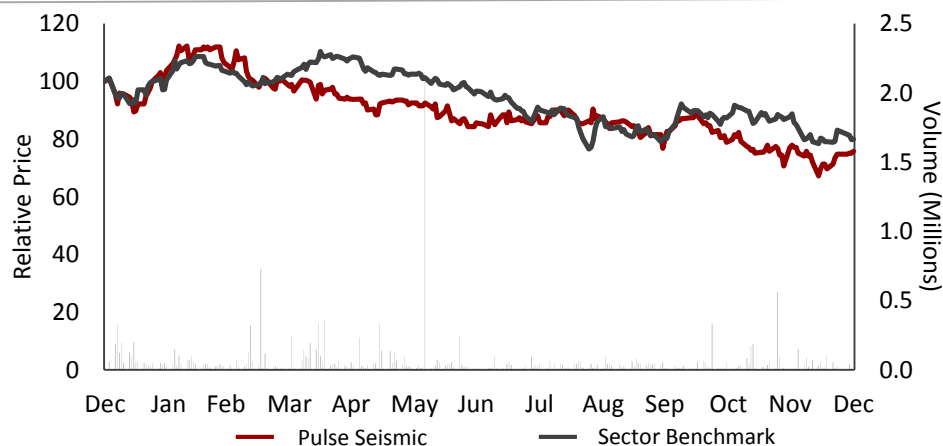
- Lower commodity prices prevent E&P companies from engaging in further exploration, which is the main driver of Pulse's traditional data sales
- Reduction in exploration and production activity in Western Canada

## Financial Summary

Public Market Overview	
<i>(values in \$mm, as of Dec. 31, 2015, except for shares outstanding)</i>	
Share Price	\$2.22
Shares Outstanding (mm)	56.4
<b>Market Cap.</b>	<b>\$125</b>
+ Total Debt	1.5
+ Minority Interest	-
+ Preferred Equity	-
- Cash	0.845
<b>Enterprise Value</b>	<b>\$125.8</b>
Beta	0.7
Dividend Yield	--
ROIC	4.94%
52-Week High	\$3.29
52-Week Low	\$1.97

Financials & Multiples	LTM	FY2016E	FY2017E
<i>(values in \$mm)</i>			
Revenue	\$24	\$29	\$20
% Growth		20%	-31%
EBITDA	\$19	\$23	\$15
% Margin		80%	75%
EPS	-\$0.09	-\$0.10	-\$0.07
% Growth		-11%	30%
EV/EBITDA	7.1x	8.9x	
P/CF	6.06x	4.36x	

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Energy index (XLE) in CAD, 60% S&P/TSX Capped Energy Index (XEG).

## Position Snapshot

Average Cost	\$2.89
# of Shares	40,973
Value Invested	\$90,960
Portfolio Weight	3.19%
2015 HPR	-24.2%
HP Benchmark Return	-20.0%
Excess Return	(4.3%)

All figures in CAD



# Pulse Seismic Inc. (TSX: PSD)

## Investment Thesis

1. **Economic moat:** Attractive business model with a very high barrier to entry
  - Pulse is considered a market leader in seismic data sales, and has very few competitors in 3D seismic data sales, which are becoming more necessary with advancing technology
2. **Low risk and defensive profile:** Company can enter hibernation mode in order to cut down on costs in periods of poor industry fundamentals
  - Owning such a straight-forward, low cost company helps minimize DCM's exposure to commodity prices during this downturn
  - The Company also provides diversification, as over 80% of the seismic data covers land with natural gas resources; exploration and production in this space is still growing
  - Pulse only requires \$7.5 million in data library sales to cover its cash operating expenses
3. **Consolidation:** Sustained low prices may lead to further consolidation in Canada
  - The company could benefit from an increased number of transactional-based sales with a possible increasing M&A trend, particularly in the WCSB
  - When an E&P company is acquired, the seismic data is not part of the purchase. Therefore, the acquiring company needs to work with the owner of the data, such as Pulse, to purchase it and survey land for future projects

## Analysis of Performance

Pulse has traded down 24% over the course of 2015 despite the continued sell-off in the energy sector. This shows the company's ability to enter into hibernation during this supply glut. Pulse has very low operating costs and can cut cap-ex without hindering near-term sales. This allowed the company to realize a 75-85% cash margin on \$24 million of sales in 2015. This coming year will likely see a continued decrease in transactional sales, although an uptick in consolidation would be a boost for the category.

DCM will be watching Pulse's ability to transfer these cash gains to shareholders, and analyze what the company growth will look like in a recovering oil price environment. In Q4 2015, the company temporarily suspended its dividend to conserve an extra \$1.1mm per quarter and act with financial prudence.

## Valuation Summary

Company	Ticker	Price	Market Cap	EV	Net Debt/ EBITDA	EV/EBITDA			P/CF (LTM)
						2015	2016E	2017E	
ION Geophysical Corp.	IO	\$0.49	\$80.26	\$213.48	-7.42x	5.36x	4.4x	11.17x	8.1x
Dawson Geophysical Corp.	DWSN	\$4.79	\$103.48	\$41.91	0.42x	7.46x	2.92x	2.73x	2.34x
Geospace Technologies Corp.	GEOS	\$9.34	\$180.96	\$127.11	-0.74x	1.8x	3.27x	3.64x	6.73x
Essential Energy Services LT	ESN	\$0.49	\$59.46	\$94.52	0.95x	3.26x	3.56x	4.11x	0.81x
	<b>Mean</b>	<b>\$3.45</b>	<b>\$109.63</b>	<b>\$120.32</b>	<b>-1.35x</b>	<b>5.06x</b>	<b>10.43x</b>	<b>6.95x</b>	<b>4.48x</b>
	<b>Median</b>	<b>\$2.14</b>	<b>\$103.48</b>	<b>\$124.59</b>	<b>0.03x</b>	<b>5.36x</b>	<b>4.40x</b>	<b>4.11x</b>	<b>4.44x</b>
<b>Pulse Seismic Inc.</b>	<b>PSD</b>	<b>\$2.14</b>	<b>\$123.98</b>	<b>\$124.59</b>	<b>0.03x</b>	<b>7.43x</b>	<b>8.59x</b>	<b>13.11x</b>	<b>4.44x</b>

- Pulse trades slightly above US and Canadian peers
- The company trades at a premium on an EV/EBITDA basis, and DCM attributes that to the low operating costs achieved by the company
- The industry is becoming more and more difficult for competitors, as seen by their price declines, so Pulse trading at a premium could indicate that it is more trusted than other companies in the industry

# Marathon Petroleum Company (NYSE: MPC)

## Company Overview

- Marathon Petroleum (MPC) is a Midstream and Downstream energy company focused on refining, transporting and marketing petroleum products
- MPC operates refineries throughout the Midwest and Gulf Coast of the United States
- MPC operates Midstream operations in conjunction with its Master Limited Partnerships (MPLX) and markets its refined products through the Speedway brand of gas stations
- MPC has grown through high-profile acquisitions of Hess gas stations chain and MarkWest gas transportation and processing facilities (acquired by MPLX)

## Catalysts

- Significant inventory build up in PADD II and III will keep refining margins relatively strong for H1 2016
- Continued integration of Hess and MarkWest will see synergies generated by cost savings and increased membership of 'Speedy Rewards' membership program
- Secular growth in low efficiency cars will mean sustained increase in gasoline demand. Light car sales in the US grew by 3% from December 2013 - December 2015, truck sales grew by 35%.

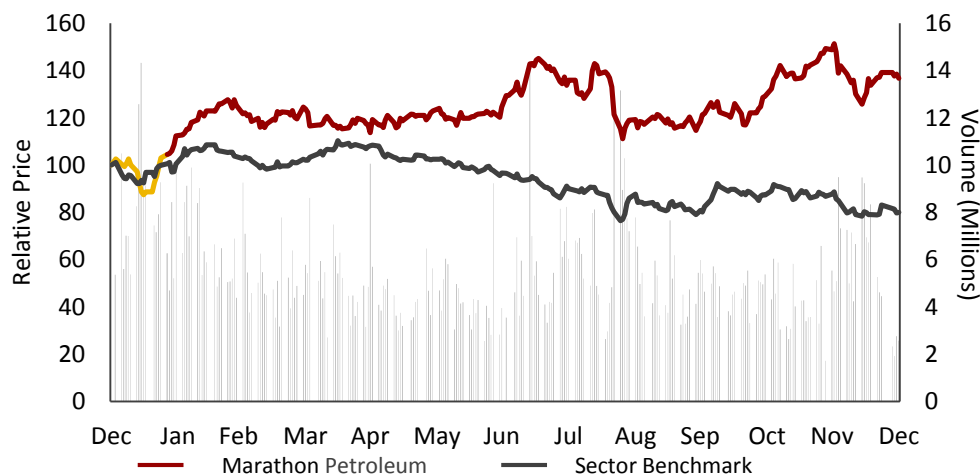
## Risks

- Refining margins will tighten if oil prices remain low in the medium term
- Continued mild winter in the US and Canada could reduce demand for refined products

## Financial Summary

Public Market Overview		Financials & Multiples			
<i>(values in C\$mm, as of Dec. 31, 2015, except for Share Price)</i>		LTM	FY2016E	FY2017E	
Share Price	\$51.84	Revenue	\$71,111	\$81,136	\$99,589
Shares Outstanding (mm)	533.0	% Growth		14%	23%
<b>Market Cap.</b>	<b>\$27,629</b>	EBITDA	\$7,102	\$6,845	\$7,058
+ Total Debt	6,692	% Margin		8%	7%
+ Minority Interest	648	EPS	\$6.15	\$5.32	\$5.86
+ Preferred Equity	-	% Growth		-14%	10%
- Cash	2,044	EV/EBITDA	7.6x	10.0x	4.0x
<b>Enterprise Value</b>	<b>\$32,295</b>	Refining Margin/Bbl		\$15.05	
Dividend Yield	3.1%	Net Debt/ EBITDA	0.72x	0.68x	0.70x
52-Week High	\$59.34	P/E	2.8x	6.93x	1.9x
		MPLX value per share	\$15.02		
		SOTP EV	\$38,655		

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Energy index (XLE) in CAD, 60% S&P/TSX Capped Energy Index (XEG).

## Position Snapshot

Average Cost	\$54.89
# of Shares	940
Value Invested	\$67,690
Portfolio Weight	2.37%
2015 HPR	30.8%
HP Benchmark Return	-20.5%
Excess Return	51.3%

# Marathon Petroleum Company (NYSE: MPC)

## Investment Thesis

**1. Strategically located assets:** Assets are primarily in PADD II and PADD III, while competitors also have exposure to less profitable areas

- Refineries and midstream assets focused on PADDs II and III allow Marathon flexibility and access to some of the lowest cost production in the Marcellus and Utica shales
- Production from Canada is expected to continue largely unchanged and MPC’s PADD II assets are positioned to receive imports from the Western Canada Sedimentary Basin
- These well positioned assets have helped MPC to generate best-in-class refining margins

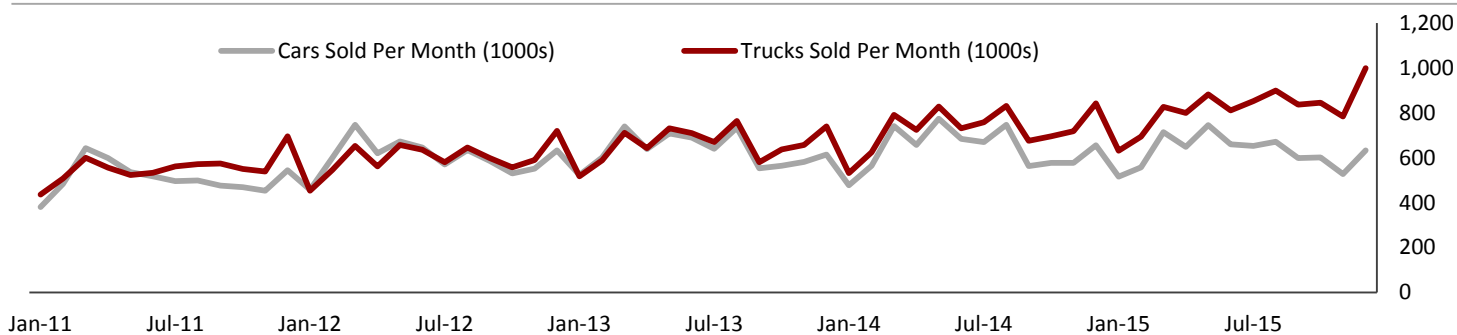
**2. MLP structure’s drop down value:** MPLX has grown significantly in 2015 through the acquisition of MarkWest Energy in a \$17.4 bn deal in July 2015

- The deal adds diversity to MPLX’s heavy oil focused infrastructure through MarkWest’s natural gas focus and North-Eastern US assets
- Combined company will be the fourth largest MLP in the US and adds fractionation capacity to MPC
- The deal further increases the drop down potential of MPC’s Master Limited Partnership, MPLX and increases the rate at which distributions can be made to MPC
- MarkWest contributes \$950mm of EBITDA to the pro forma 2015 estimated EBITDA of \$1,250 mm, this acceleration of MPLX’s growth specifically benefits MPC due to the exponential growth of the GP’s share of distributions as total distributions rise

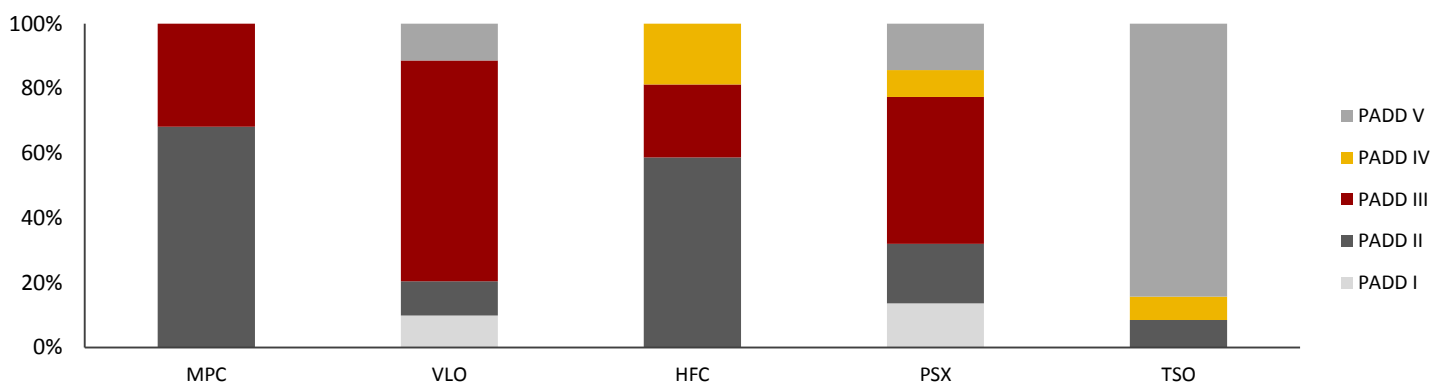
**3. Diversification of revenue streams:** Marathon has shown a commitment to diversifying from its core refining business which will insulate the company from adverse macro events more than competitors

- Hess acquisition has been successful and conversions of stores are ahead of schedule, giving Marathon potential to move further in the marketing space
- Management has confirmed commitment to growing marketing segment through acquisitions and is rumored to be interested in bidding for CST Brands chain of gas stations

## Prolonged period of low gas prices is sewing the seeds for higher future demand

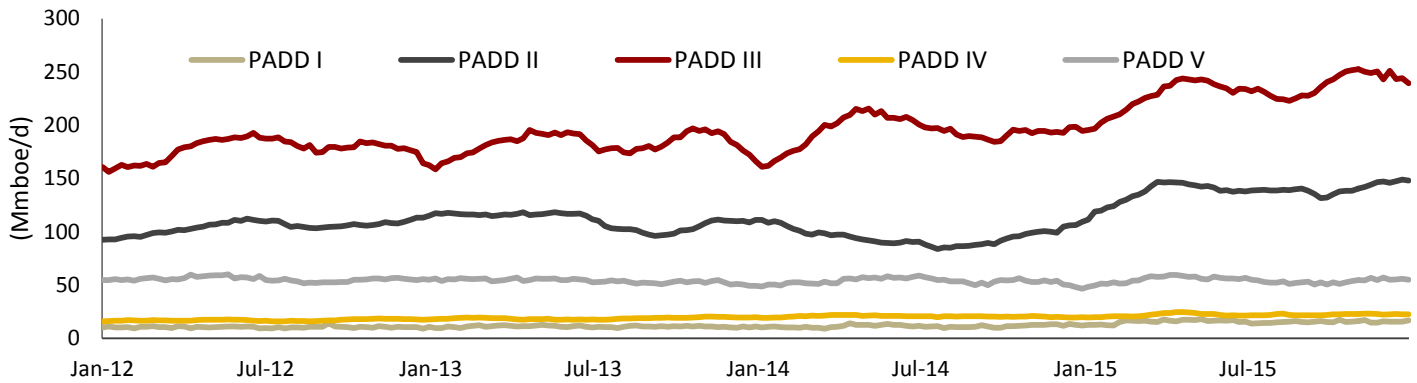


## MPC best placed US refiner to profit from PADD II and III supply glut



# Marathon Petroleum Company (NYSE: MPC)

Crude stocks by region



## Year In Review

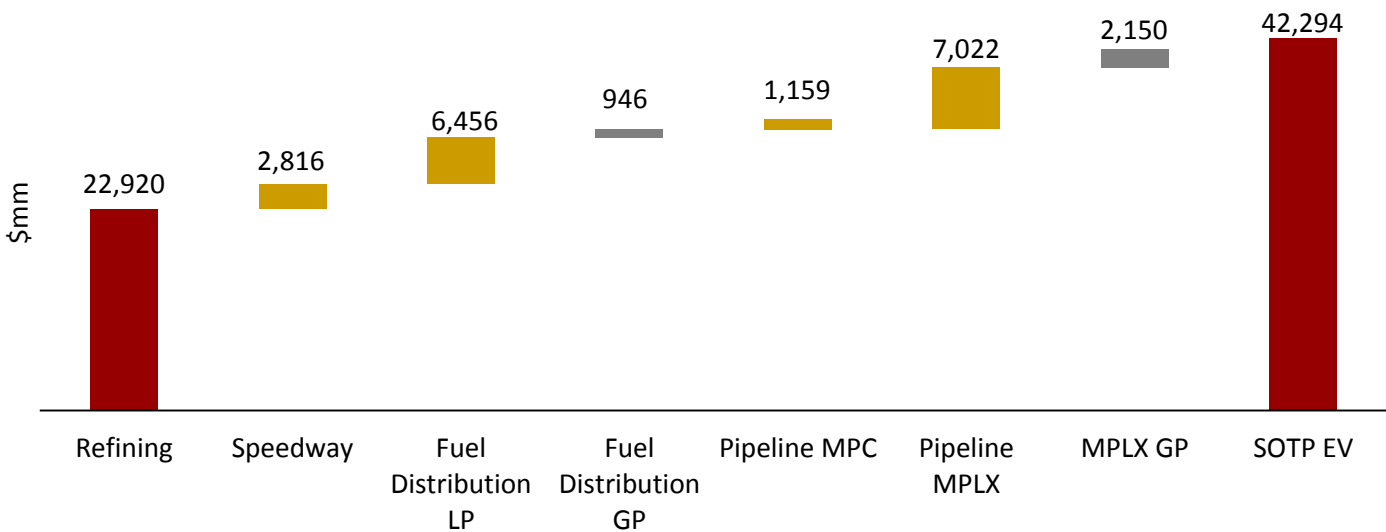
Throughout 2015 management took steps to diversify Marathon’s revenue streams towards more stable segments in anticipation of tighter crack spreads in the future. The focus on midstream and retail was extremely clear in 2015 through the acquisition of MarkWest and continued integration of Hess gas stations as a priority. Management has stated that they aim to shrink refining as a share of EBITDA from 80% in 2015 to closer to 45% by 2020 and will continue to grow their non-traditional segments to do this.

## Analysis of Performance

MPC was a top performer for our portfolio in 2015, however, it appears undervalued in comparison to competitors and intrinsic value. MPC’s refining margins consistently outstripped competitors during 2015 due to access to the supply rich regions of PADDs II and III. Management prioritized the growth of more stable revenue segments which come with the trade off of lower margins, such as pipelines and retailing. The stock has suffered at the hands of investors for this approach during a year of record-high crack spreads, however, it will also leave them best positioned to weather a period of tighter refining margins that is to be expected over the coming years if crude prices remain low.

## Valuation Summary

Based on our Sum of the Parts valuation, MPC appears to be undervalued by approximately 30% at current levels due to the market failing to price in an adequate premium in terms of refining margins and underestimating the rate of growth of distributions from MPLX



Figures are in millions of \$US

# Parex Resources (TSX: PXT)

## Company Overview

- Parex Resources (PXT) is a Canadian E&P company, which operates in Colombia's Magdalena and Llanos Basins
- PXT has successfully grown reserves in Llanos basin through farm-in projects with the government, and is now focusing on Magdalena for growth opportunities
- Management has raised its base case 2016 capital expenditures to \$165mm from \$155mm in 2015, with a projected year on year growth in production of 10%
- PXT has average daily production of 22,850 boe/d and 2P reserves of over 70mm barrels

## Catalysts

- Continued weakness of the Peso and operational improvements have continued to put downward pressure on costs
- Political scandals in Venezuela and Brazil makes Colombia relatively attractive to investors
- One off tax hit this year through restructuring of subsidiaries will mean lower future tax expenses, projected to be below 10%

## Risks

- Colombia is a complicated business environment compared to Canada due to political instability
- Ballooning dual deficits may require action from Colombian government and central bank to stabilize the economy

## Financial Summary

### Public Market Overview

(values in C\$mm, as of Dec. 31, 2015, except for Share Price)

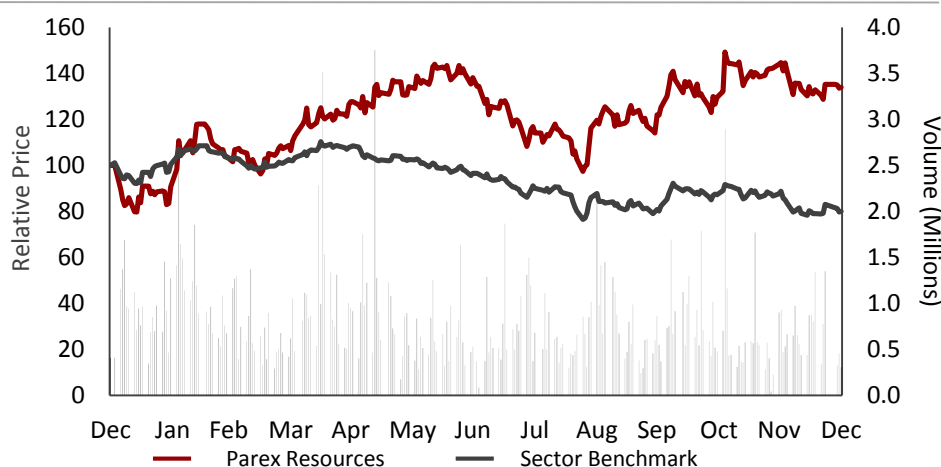
Share Price	\$10.19
Shares Outstanding (mm)	134.7
<b>Market Cap.</b>	<b>\$1,387</b>
+ Total Debt	0
+ Minority Interest	-
+ Preferred Equity	-
- Cash	109.4
<b>Enterprise Value</b>	<b>\$1,278</b>
Beta	1.99
Dividend Yield	--
ROIC	21.4%
52-Week High	\$11.55
52-Week Low	\$5.97

### Financials & Multiples

(value in C\$mm)

	LTM	FY2016E	FY2017E
Revenue	\$526	\$535	\$643
% Growth		-19%	19%
EBITDA	\$157	\$175	\$264
% Margin		38%	52%
EPS	\$-0.44	\$-0.30	\$0.01
% Growth		-91%	464%
EV/EBITDAX	3.69x		
EV/PROD	16.06x		
P/CFPS	3.08x		
Riskd NAV/share	\$15.38		
P/NAVPS	0.5x		

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 40% U.S. Energy index (XLE) in CAD, 60% S&P/TSX Capped Energy Index (XEG).

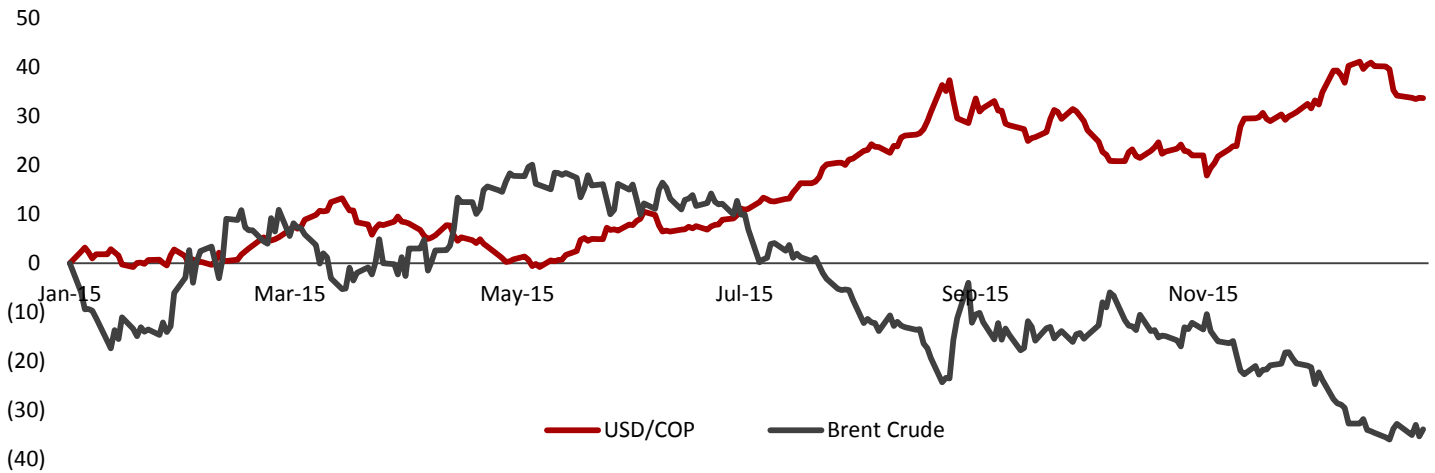
## Position Snapshot

Average Cost	\$7.30
# of Shares	8,060
Value Invested	\$81,890
Portfolio Weight	2.87%
2015 HPR	34.0%
HP Benchmark Return	-20.0%
Excess Return	54.0%

All figures in CAD

# Parex Resources (TSX: PXT)

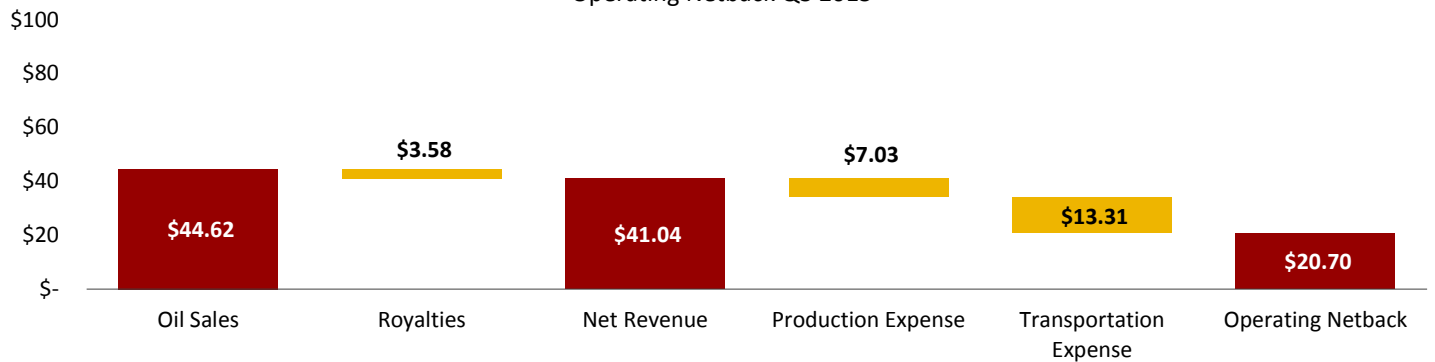
## Falling crude price drag down the Peso



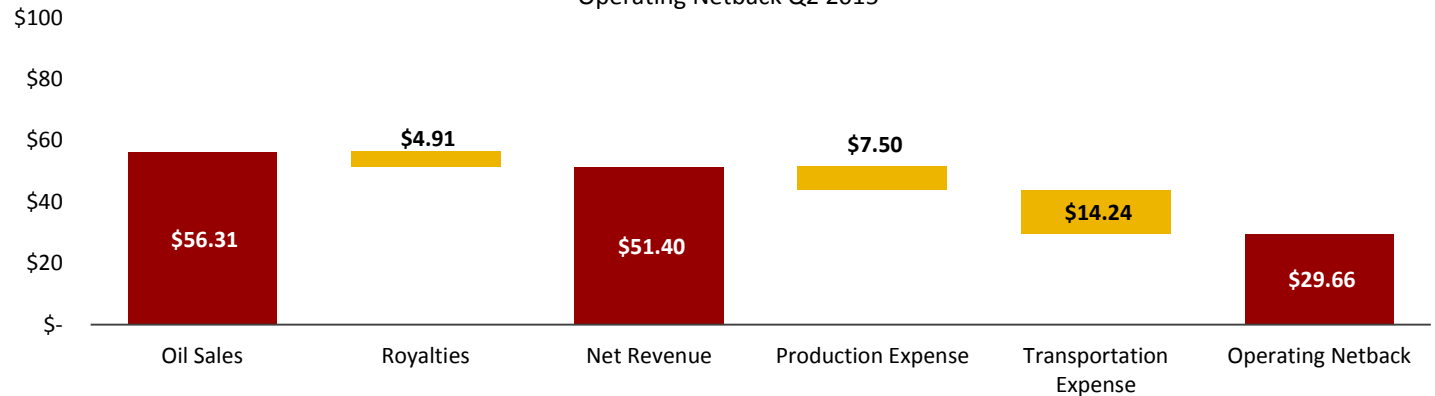
## Maintaining high netbacks despite low prices

- The Colombian Peso fell 30% against the dollar over the year due to the deterioration in the country's balance of payments
- Parex has taken advantage of the falling Peso and improving efficiency, bringing operating costs per barrel down by 32% year on year
- If PXT can keep costs low, if and when benchmark crude prices recover, the company will be able to realize far higher netbacks than North American producers

Operating Netback Q3 2015



Operating Netback Q2 2015



# Parex Resources (TSX: PXT)

## Investment Thesis

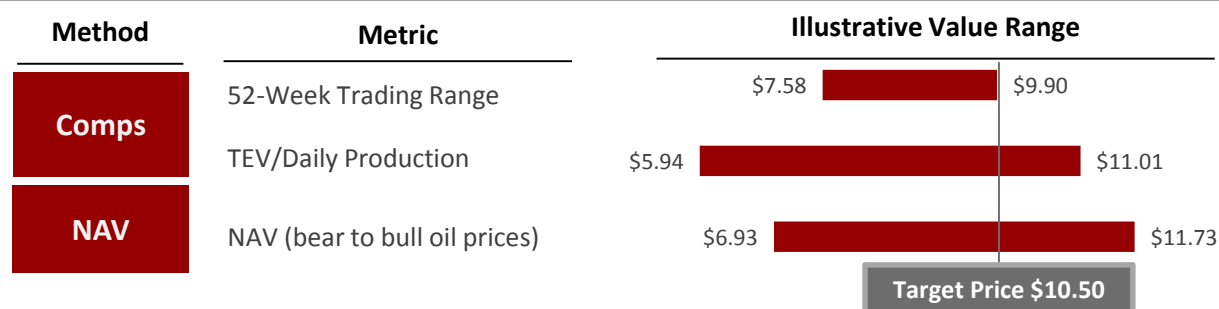
- 1. The Colombian E&P market is heavily discounted:** There is a discount priced into the stock because of the perceived risk in the Colombia E&P market, which appears overestimated
  - The peace process may be completed by Q2 2016, increasing investor confidence in the country
  - Attacks by FARC rebels were not uncommon in 2015, however these attacks occurred mostly in the south-west of the country, far away from PXT's operations
- 2. Balance sheet strength and operational success story:** Parex's lack of debt, backed up by the revolver capacity and strong working capital position despite the weak industry conditions, should warrant a premium to competitors
  - Parex has paid off all external debt and retains \$200m of unused revolver
  - PXT has enjoyed significant operational success and has continued to grow reserves and production
- 3. Macro environment in Colombia provides high netback opportunity:** The weakness in the Peso will help to keep costs low for Parex, relative to realized sales prices
  - Oil makes up over 50% of Colombian exports; the fall in oil prices has led to a current account deficit and depreciation in the Peso
  - Stable economic conditions relative to Venezuela and Brazil will make Colombia a more attractive target for LatAm energy investors

## Analysis of Performance

Parex was one of highlights of the energy portfolio this year, bucking the negative trend among E&P companies. Parex has outperformed when compared to North American producers due to the depreciation of the Colombian peso and falling oil price cutting costs, which has softened the blow to netbacks. PXT's net sales price fell by \$42 from Q3 2014 to Q3 2015, but cost savings meant that netbacks only fell by \$32 in the period.

Parex's operational efficiency and high quality assets should yield a higher valuation than at present. When compared to North American competitors the company is trading at a still unwarranted discount. Investors may be hesitant about Colombia as an investment destination, however a resolution of the peace process scheduled for March 2016 should end some of these concerns. Rising tensions in Venezuela, as well as increasing warning signs from Brazil, should make Colombia an attractive alternative for LatAm E&P investors.

## Valuation Summary





# Technology, Media, & Telecommunications Sector

2015 Review & 2016 Outlook

*By Henri St-Pierre, Luohan Wei, Tony Ren, and David Marcovitch*

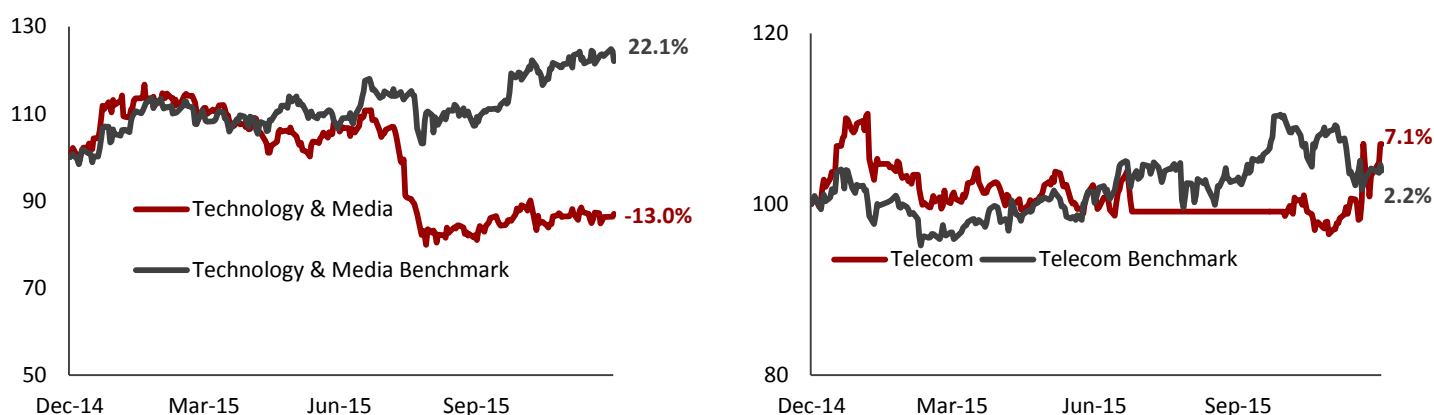


## 2015 Sector Performance

### DCM Performance

The Global Equity Fund's Technology, Media & Telecommunications (TMT) sector returned -13.0% in 2015 versus 22.1% for our sector benchmark. The TMT benchmark was the 3rd best performer of all DCM's blended sector benchmarks in 2015 due to many factors, which include significant gains from large cap technology stocks, such as Google and Facebook. Breaking down the sector into technology/media and telecommunications provides further insight into our relative performance. Our technology/media holdings underperformed their benchmark by 35.0% while our telecommunication holdings outperformed their benchmark by 4.8%. Our underperformance in the technology/media sector was largely due to the underperformance of Teradata and YuMe. These two stocks were also responsible for our sector underperformance in 2014 and we have since exited both positions as the original investment theses did not seem likely to play out given material events in 2015. Our telecommunication holdings' outperformance can be explained by our recent investment in Cogent Communications, which appreciated 3% by the end of the year since our investment in November, while the overall industry declined.

Figure 1: TMT performance vs Benchmark



### 2015 Performance Analysis

2015 was a year of learning and transition for the TMT team. We started the year with investments in highly volatile stocks, which ultimately led to significant losses despite a great year for the TMT industry as a whole. Since then, we have aimed to rebalance our portfolio around less volatile stocks that still have significant upside potential, but whose operating performance is much less reliant on growth relative to our previous investments.

In the technology and media sector, we started the year with investments in Teradata, YuMe, Intel, Time Warner and Amazon. Going into 2016, we have only continued to hold onto Intel and Time Warner. For 2015, our performance was on par with benchmark returns up until Q3 2015. Around the same time, we also saw the values of both Teradata and YuMe fall against our initial predictions. Teradata, a provider of data warehousing and analytics, suffered from the continued growth of open-source software solutions based on Hadoop architecture. Despite numerous attempts to offer a competing Hadoop based solution to their clients, the company was unable to withstand the losses in their core business, causing a decrease in their stock price and leading to our ultimate decision to sell.

YuMe, a digital advertising platform, failed to deliver on growth expectations that were priced into the stock. For a small cap tech stock, slowing growth is a death sentence in the eyes of investors, who flocked away from the YuMe story. We saw that the growth of programmatic advertising, a new technology to instantly place advertising on digital platforms, hurt YuMe's own prospects as less than 10% of their business was tied to programmatic advertising. Ultimately, our analysis of the upside potential for YuMe in 2016 limited itself to an acquisition from a larger tech player, as we failed to see how the core business could deliver on the growth prospects that were originally expected and we decided to exit the position.

Source: S&P Capital IQ, Bloomberg

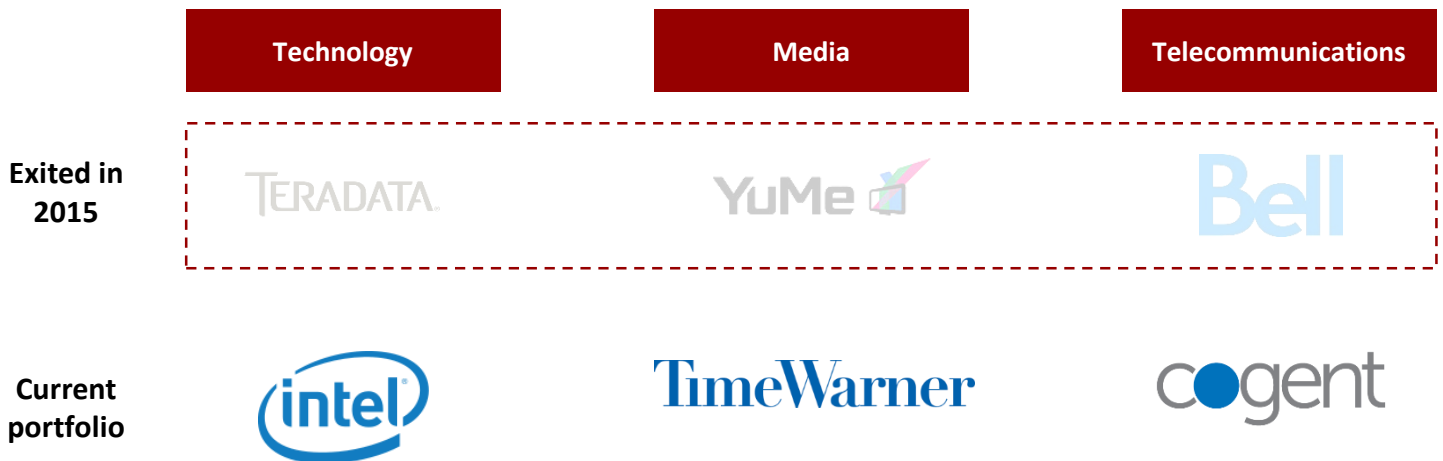
## 2015 Sector Performance

Looking at our telecommunication holdings, we decided to exit our position in BCE following material events over the summer, when the CRTC ruled that fiber assets were not excluded from third party wholesalers, implying that Bell would have to share their expensive fiber network with wholesalers and severely limiting the ROI on these capital intensive projects. With BCE having most of its revenues generated from their wireline segment, we failed to see the next growth catalyst once IPTV reaches the end of its growth trajectory as Fibe has nearly fully penetrated the Canadian market for Bell. The market may continue to expect a turn-around of the wireline business; however, we believe that the new CRTC ruling is a major cause for concern and will result in a declining wireline business.

We also initiated a position in Cogent Communications, which is a pure-play corporate wired internet access provider that is seeing double digit revenue growth in a stagnant industry. We believe that at current prices, the market does not believe that Cogent will be able to sustain its high growth. However, Cogent's superior fiber network should allow the company to continue gaining share against its competitors at historical rates. Those penetration rates could even increase should companies demand even more data with the onset of data hungry applications such as Cloud-based services and video conferencing.

The TMT portfolio has undergone a major repositioning in the past year. We sold our highly volatile positions and we are now diversified across multiple unrelated industries, including media and telecommunications, sectors which are more stable, yet where we feel excellent opportunities still exist.

**Figure 2: TMT Repositioning 2015-2016**



### 2015 TSR Decomposition

A decomposition of returns is necessary to understand which companies and what sectors drove the majority of the value in a given period. Total shareholder return can be broken down into three components: fundamental value, expectations, and cash flow effects. Fundamental value is broken down further into sales growth and EBITDA margin. The change in EV/EBITDA multiple reflects changes in shareholder expectations on the future outlook of performance. Finally, cash flow effects include dividend yield, buybacks, and debt repayments (change in MV/EV ratio). The table on the following page lists the top 20 S&P 500 companies ranked by 2015 Total Shareholder Return (TSR).

A vast majority of firms with the highest 2015 TSR in the S&P 500 were firms affiliated with internet and technology. While Amazon and Netflix are categorized by S&P as Consumer Discretionary, their business models revolve around the internet and are most often analyzed by tech analysts. To paraphrase the thesis of renowned VC firm Andreessen Horowitz – software is eating the world.

Source: S&P Capital IQ, Bloomberg

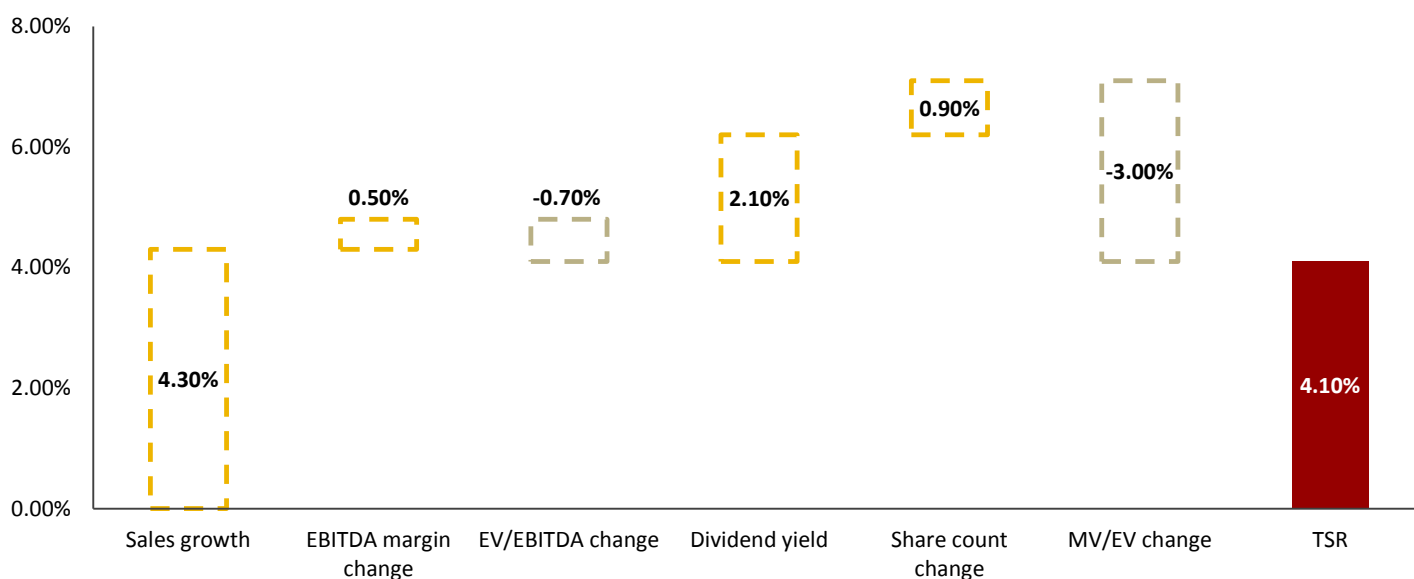
## 2015 Industry Analysis

**Figure 3: Top 20 S&P 500 Companies by 2015 Total Shareholder Return**

Company name	Sector	TSR	Sales growth	Margin change	Multiple change	Dividend yield	Share change	MV/EV change
Netflix, Inc.	Consumer Discretionary	131.6%	28%	-13%	121%	0.0%	-0.9%	-3%
Amazon.com, Inc.	Consumer Discretionary	94.5%	21%	12%	62%	0.0%	-1.0%	1%
Activision Blizzard, Inc.	Information Technology	78.1%	14%	6%	53%	0.6%	-1.4%	5%
Reynolds American Inc.	Consumer Staples	74.0%	19%	12%	59%	3.0%	-10.0%	-8%
First Solar, Inc.	Information Technology	67.5%	7%	-27%	85%	0.0%	-0.5%	3%
NVIDIA Corporation	Information Technology	66.3%	6%	6%	60%	1.4%	2.6%	-9%
Expedia Inc.	Consumer Discretionary	65.8%	28%	10%	37%	0.9%	0.3%	-10%
Tesoro Corporation	Energy	61.2%	-10%	-11%	87%	2.1%	3.0%	-9%
Dollar Tree, Inc.	Consumer Discretionary	53.6%	81%	-28%	32%	0.0%	-4.2%	-27%
Harris Corporation	Information Technology	52.1%	61%	-8%	20%	2.4%	-4.5%	-20%
Cablevision Systems Corporation	Consumer Discretionary	49.9%	2%	2%	16%	1.9%	-1.5%	29%
Hormel Foods Corporation	Consumer Staples	49.8%	3%	7%	39%	1.5%	-0.1%	-1%
Monster Beverage Corporation	Consumer Staples	47.5%	16%	12%	23%	0.0%	-7.6%	4%
VeriSign, Inc.	Information Technology	46.8%	7%	2%	31%	0.0%	8.1%	-1%
Avago Technologies Limited	Information Technology	44.3%	6%	9%	24%	1.4%	-5.2%	9%
Total System Services, Inc.	Information Technology	43.4%	7%	-3%	31%	0.9%	0.8%	8%
Starbucks Corporation	Consumer Discretionary	42.7%	13%	3%	25%	1.4%	0.5%	-1%
Valero Energy Corporation	Energy	42.3%	6%	-14%	41%	3.0%	3.7%	3%
Alphabet Inc.	Information Technology	42.3%	14%	3%	29%	0.0%	-1.0%	-3%
Electronic Arts Inc.	Information Technology	41.6%	7%	18%	20%	0.0%	0.4%	-2%

What allows TMT companies to exceed its peers in terms of performance and deliver the greatest value? While margins and multiple expansion have a strong correlation with average levels of valuation across all sectors, revenue growth within the TMT space has become the determining factor in 2015. As noted below, the largest contribution to total shareholder return (TSR) in 2015 was revenue growth. TMT companies are being compensated by the market for operational performance rather than future expectations of performance, as EV/EBITDA multiples compressed in the latter half of the year. Multiples declined due to market-wide corrections and declining expectations for “growth” stories in high flying sectors like IT and internet.

**Figure 4: IT & Telecom 2015 TSR Breakdown**



Source: S&P Capital IQ

## Spotlight on Information Technology: Software Eats The World

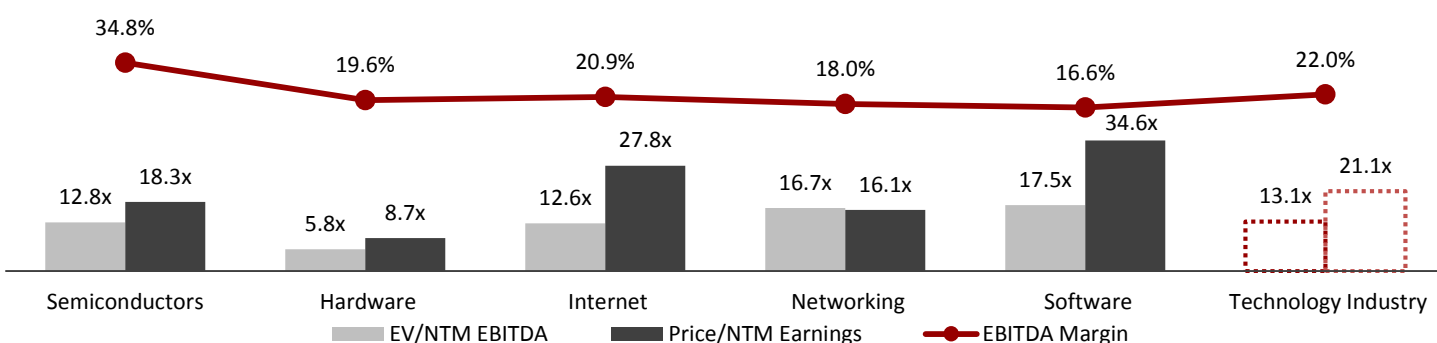
In the TMT sector, a large portion of our attention revolves around internet technology. As an industry group whose products increasingly permeate the S&P 500, it is an essential backbone of productivity growth and economic growth. In this industry, there was a large variance of performance in 2015. As noted below, Home Entertainment Software companies like Activision and Electronic Arts dominated 2015 with an average TSR of 60%, driven mostly by increasing expectations (EV/EBITDA multiples) and sales growth. On the other end, hardware and component companies like Western Digital, Apple, and Corning performed poorly this year, with underperformance also mainly driven by changes in valuation multiples as well as sales growth.

**Figure 5: IT 2015 TSR Breakdown by Subsector**

	Share performance	TSR	Sales growth	Margin change	Multiple change	Dividend yield	Share change
<b>Information Technology</b>	<b>4.2%</b>	<b>5.5%</b>	<b>4.4%</b>	<b>0.4%</b>	<b>-0.6%</b>	<b>1.8%</b>	<b>1.3%</b>
Home Entertainment Software	69%	60%	10%	12%	36%	0%	0%
Application Software	17%	19%	10%	3%	7%	0%	0%
Internet Software and Services	21%	19%	13%	1%	7%	0%	1%
Semiconductors	13%	15%	2%	-3%	16%	2%	0%
Data Processing and Outsourced Services	9%	11%	10%	0%	-1%	2%	1%
Systems Software	-1%	1%	-4%	7%	-4%	2%	2%
Electronic Manufacturing Services	2%	1%	-1%	2%	-7%	2%	1%
Communications Equipment	-10%	-1%	15%	0%	-15%	2%	1%
IT Consulting and Other Services	-6%	-4%	3%	3%	-11%	2%	2%
Semiconductor Equipment	-9%	-6%	3%	4%	-10%	2%	2%
Electronic Equipment and Instruments	-13%	-11%	5%	1%	-20%	1%	1%
Technology Hardware, Storage and Peripherals	-34%	-34%	-11%	-7%	-23%	4%	4%

For the most part, multiples for individual verticals are driven by growth expectations. Software is expected to grow in the 4-6% range in 2016 while hardware is expected to decline by 3-5%. As noted below, the software vertical is now expensively priced relative to other technology verticals. Software's growth expectations are mainly driven by the growth in cloud services and SaaS.

**Figure 6: IT Vertical Multiple and Margin Expectations**



The DCM TMT team ranked each tech vertical by 2015 TSR and by EV/EBITDA valuation to understand which vertical ended 2015 in the most attractive manner. The semiconductor space performed very well in 2015 due to industrial growth and better-than-expected PC sales. Since valuations remain attractive, the DCM TMT team will continue sourcing ideas from the semiconductor space.

**Figure 7: IT Verticals 2016 Outlook**

By TSR	By Valuation	Aggregate
1. Software	1. Hardware	<b>1. Semiconductors</b>
2. Semiconductors	2. Semiconductors	<b>2. Networking</b>
3. Networking	3. Networking	<b>2. Hardware</b>
4. Internet	4. Internet	<b>2. Internet</b>
5. Hardware	5. Software	<b>3. Software</b>

Source: S&P Capital IQ

# 2015 Industry Analysis

## 2015 Industry Review

One of the biggest factors in the TMT space is disruption. Disruption theory attempts to explain how companies that build products in the high end (print encyclopedias) could be disrupted by upstart companies that started at the low end (Wikipedia) and gained share.

Companies with products that make other products obsolete (Uber with taxis, iPhone with digital cameras) now have the ability to gain share quickly with low customer acquisition costs. The Internet has driven marginal customer acquisition cost significantly downward, leading to immense scale advantages. This year, the TMT team has invested in companies that are strategically positioned to benefit from this hyper-scaling of digital traffic. From the bottom (wireless towers and internet transit pipes) to the top (over-the-top content delivery), we are heavily invested in relatively secure businesses throughout the digital stack.

At DCM, we do not view TMT as one sector. The business model of creating content for movie studios is completely different from manufacturing hard drives for data centers or providing cellular service to rural customers. We prefer to split this sector into specific themes, and play off attractive investments in each space.

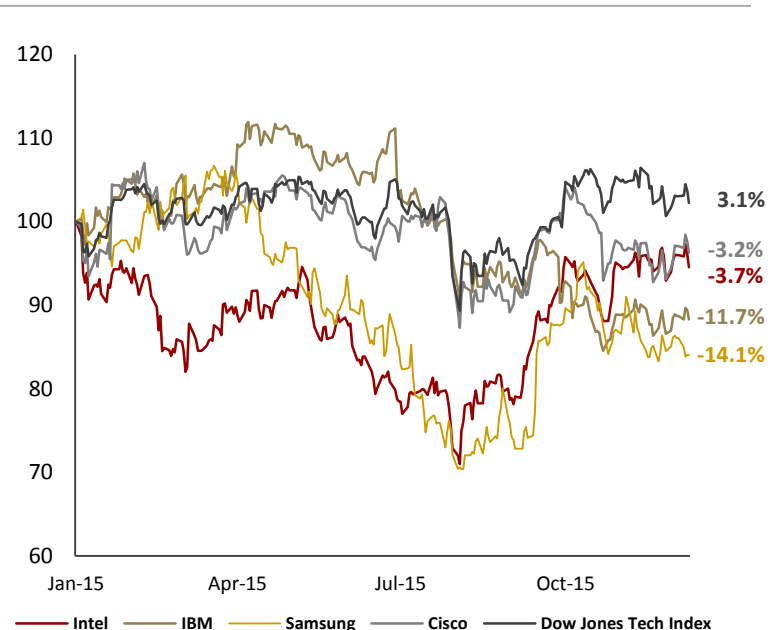
### Hardware and the Cloud

While in 2014 the theme du jour was Internet of Things, 2015 brought the theme back into reality. While the market priced in growth from mobile sensors, it was too early to bet on which company will disrupt this space. As noted below, large companies known for their exposure to growth in IoT such as IBM, Samsung, Intel, and Cisco have all underperformed the Dow Jones Tech Index.

A picks and shovels investment case can easily be made for investing in companies that produced the sensors, like Intel or Qualcomm.

DCM TMT remains bullish on Intel due to its stronghold on semiconductor innovation and exposure to both IoT and cloud service growth. Please note Intel's performance review section for a clear description on why Intel ended the year with flat performance.

Figure 8: IT Large Cap 2015 Performance



### Media, Telecommunications, and the Smile Curve

In the media space, digital advertising was the fastest growing category in 2015, with McKinsey reporting a 16.1% revenue increase over 2014. Print advertising and publishing remained on the low end of the space. Yet, the only ad-tech stocks that performed in 2015 were Facebook and Google, with smaller tech advertising players like Yume and Rocketfuel underperforming the S&P by more than 40%. The story is similar with these smaller players; meeting growth expectations is expensive and leads to drags on profit.

### Digital expansion

We believe the growth in digital media will be driven by an expansion in broadband connection points. Companies like Cogent Communications that provide internet access and transit between these connection points will benefit from increasing demand for their services. As mobile becomes a principal digital connection point, digital spend will increase, benefiting the strongest e-retailers (like Amazon).

Source: S&P Capital IQ

# 2015 Industry Analysis

## Content Aggregation

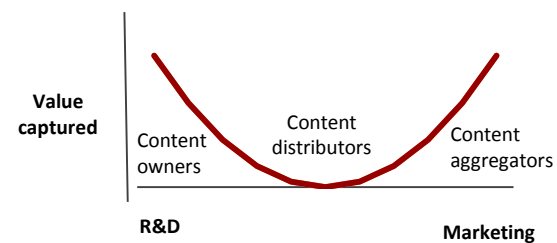
A value chain can be divided into suppliers, distributors, and consumers. Monopolizing a space isn't enough to sustain advantage anymore, as it has become much more important to act as *the* customer access point where customers get content. Suppliers now have to focus heavily on their content and their user experience to differentiate themselves. For example, Netflix users would see much less value in Netflix if Netflix didn't aggregate its content so it was available at any time. Facebook has a different business model where its suppliers are its users and its customers are the advertisers. The users supply data; the advertisers use this data. Advertisers would see much less value in Facebook if Facebook did not aggregate its user data into one combined network.

## Cord Shaving

Quality content is important, but so are the unit economics. This is why bundling is going to remain important, even with the increase in cord shaving. There is no economical model where it makes sense to only pay for the shows you watch, as this model becomes much more expensive over time and limits the user experience. Bundling benefits sellers *and* buyers. Consider a sports viewer and a Game of Thrones viewer. Both enjoy premium content, yet both have different preferences on what they would like to primarily spend time watching. The sports viewer is willing to pay \$10/mo for ESPN and only \$3/mo for HBO, while the Game of Thrones viewer is willing to pay \$10/mo for HBO and \$3/mo for ESPN. If the cable company were to set individual prices, it would have to set prices at a maximum of \$10 for HBO and \$10 for ESPN, for a total revenue of \$20. If it were to bundle the channels together and charge \$13, total cable revenue would increase and both viewers would be indifferent. Bundling is the reason business models like Spotify and Apple Music are taking over a la carte options. We view TV bundling as here to stay. The manner in which consumers access bundles (whether through a cable channel or internet streaming service) may change, but the economics will not. However, there is a legitimate media movement towards "skinny bundles", or smaller bundles that contain the channels that consumers are most willing to pay. Companies like Time Warner, who have quality content and fewer channels, will be protected from bundle shaving more so than others such as CBS and Viacom.

While media valuations were reaching expensive levels in the front end of 2014, the fear stemming from cable cutting hit most media players causing valuations to tank in early 2015. TMT at DCM prefers investing in an environment of fear and speculation. We entered a position in Time Warner due to its high value content and low exposure to a declining advertising space. We like to decompose the media space with a graph called the "Smile Curve."

Figure 9: The Smile Curve



This curve describes how the profit in an industry can be distributed among content owners, content distributors, and content aggregators. Content creators like Disney own the IP that is highly valued by consumers. The possible means of distributing such content is expanding, whether through mobile phones, cable TV, or internet streaming. There is high pressure amongst distributors to compete for this content, driving down the potential value in this segment.

Finally, content aggregators like Facebook and Google merely own the point in which consumers can discover content and share with friends, and they have tremendous value in aggregating consumer data. TWX is first and foremost a content creator. It benefits from its portfolio of premium content that will withstand the pressures for skinnier cable channel bundles. TWX's channels will not be dropped.

Figure 10: Skinny Bundle Example



Source: S&P Capital IQ

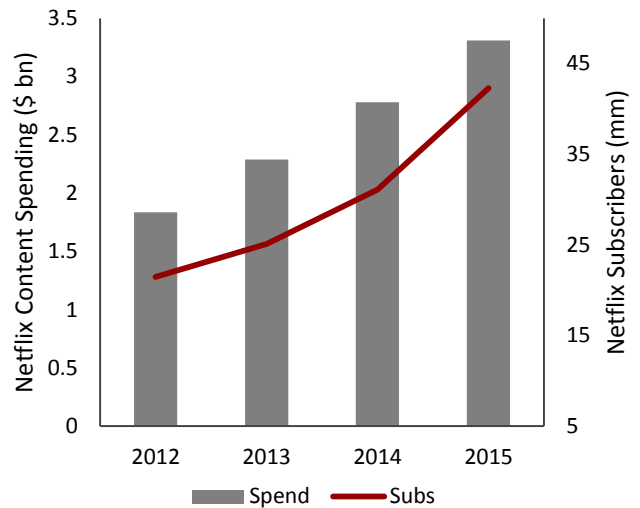


# 2015 Industry Analysis

## Transition to Online

While it may seem reasonable to assume that cord cutting is a negative trend for traditional media companies, the relationship is not so obvious. Clearly, affiliate fees and advertising revenue will decline as there are fewer people inside the TV ecosystem. However, media conglomerates can make up for these losses through online licensing deals with OTT providers. Consider Daredevil (hit Netflix Original Series) as an example. The fact that the show was distributed over the internet vs. TV is irrelevant to the media producer (Disney). In both cases, the media producer is compensated for their content. In summary, Netflix subscriber growth simply translates to Netflix contributing more to overall media content spending (Figure 3). Moreover, media companies may actually benefit as more buyers naturally drives up the price of content. Lastly, media companies can sell their own content OTT using their own distributional channels (without Netflix). Time Warner has successfully illustrated this model via its launch of HBO NOW.

**Figure 11: Netflix Subscriber Growth Rate in Relation to Content Spending**

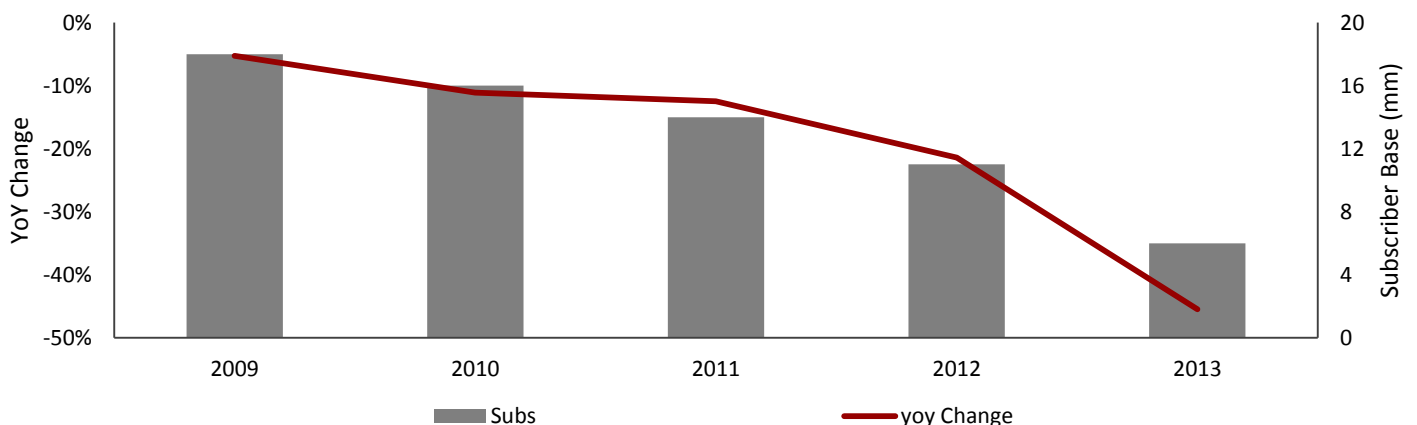


## Telecommunications and the Fight for Broadband

The fight for broadband subscribers over the past few years has been in favour of cable companies taking market share from Telco DSL customers which cannot offer the speeds that cable providers can with their superior network. In 2015, Cable accelerated their subscriber growth to 6.4% while Telcos lost customers as their subscriber base shrunk by 0.3%.

However, cable market share increases might be slowing down as they start to face tougher competition from FTTN/H networks rather than the older DSL networks from which they have been gaining share over the last few years. This dynamic is further strengthened by the \$12.5 bn fiber capital plan that AT&T included in the DirecTV acquisition to gain regulatory approval. This influx of capital to build out new areas with fiber, as well as the existing saturation of cable market share in existing DSL regions, may cause a reversal of the tide of the last 5 years and see Telco providers stem the subscriber losses to cable. Cable’s market share growth over the last few years has come at the expense of DSL customers. However, going forward, the depletion of the DSL subscriber base as well as increased investments in fiber from Telcos (Figure 12) will make it harder for cable companies to continue growing their subscriber bases at historical levels.

**Figure 12: Declining Legacy DSL (< 3 mbps) Subscriber Base**

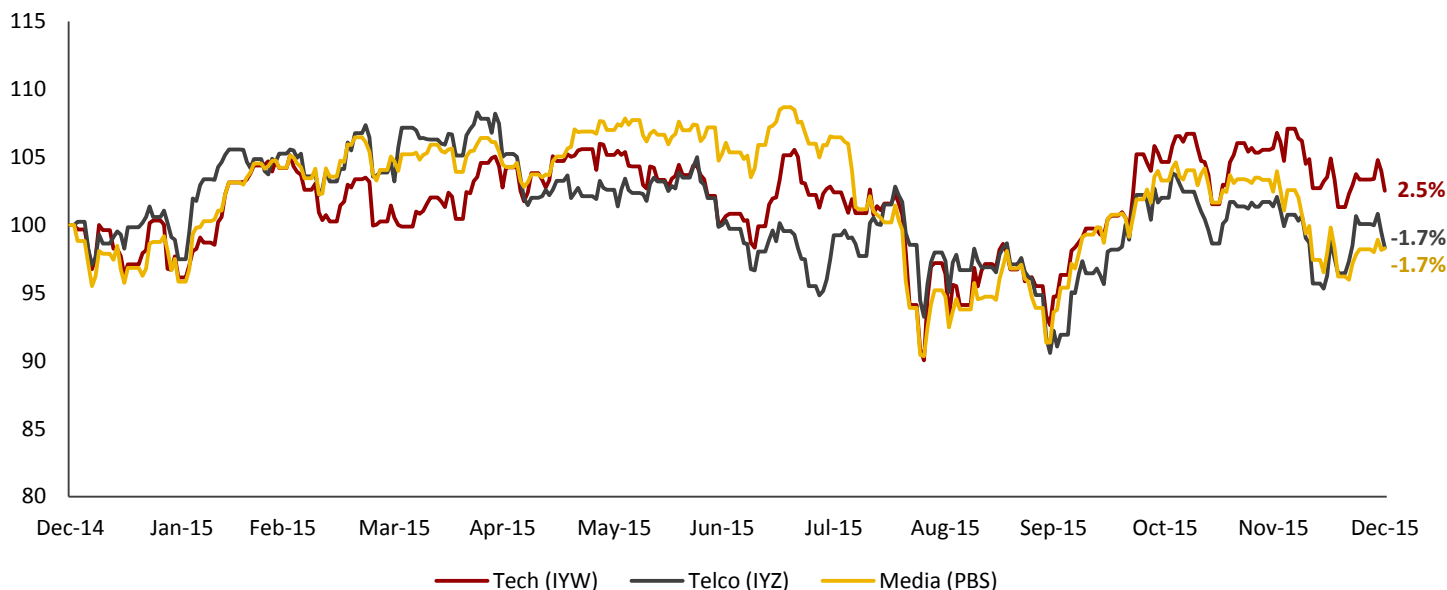


Source: MoffettNathanson



## 2015 Industry Analysis

Figure 13: US Tech, Telco, and Media 2015 Performance Follow a Similar Pattern



The performance chart for the Dow Jones Technology Index is misleading as the index is heavily tilted towards Facebook (6% weight), Alphabet (13% weight) – two expensive stocks that have driven returns for the overall market.

While the S&P overall finished 2015 down less than 1%, the returns of Facebook, Amazon, Netflix, and Google averaged 83%. Netflix trades above 300x earnings, Facebook at 100x earnings, and Amazon at 900x earnings. While there may be a time and place for speculative growth investments, we are more comfortable avoiding stocks of this nature in order to maintain our value investing principles. These decisions may hurt us in years where large-cap growth stocks outperform their smaller cap peers, but we believe the long-run will witness our margin of safety pay off. Goldman Sachs stock strategist David Kostin noted that large-cap internet stocks such as the FANG companies outperform in periods of low economic growth, as “modest US economic growth and peak margins should put a premium on stocks with perceived high secular growth prospects.” We believe this insurance against credit tightening is priced in.

### 2016 Outlook: High Valuations Will Compress; We Look for the Value

Our investments in the TMT sector in 2015 were primarily catalyzed by specific themes we found attractive; we only invested in stocks that fit the core principles of our value investing foundation. We remain cautious for 2016, as some of the riskier names in the TMT sector have become very expensive. Expectations are boundless, and so are the multiples. DCM will focus its attention on two specific themes for 2016.

#### Invest in the Value Disruptors

Companies like HP, IBM, EMC, and Dell are finding themselves disrupted by new players in the space such as Amazon. While we remain bearish on legacy businesses, there is significant value to capture in investing in companies with strong FCF generation that are switching focuses into the cloud and enterprise analytics space.

#### Avoid the Expensive Growth Stories

As many financial commentators like to note, the biggest taxi company owns no cars, the biggest hotel chain owns no beds, and the biggest retailer owns no stores. These companies, whether private or public, have captured the attention of many investors. It will be difficult to be diligent and only invest in stories that have fair prices.

Main benchmark: (IYW) – The Dow Jones US Technology Index

## 2016 Outlook: From Bricks to Bytes... Back to Bricks?

### Semiconductors an Attractive Space to Invest in Looking at 2016

At first glance, the Semiconductor space seems to be saturated and mature. This is partly true – the industry is dominated by large and established international corporations that have been around for decades, but the growth profile and opportunities are not characteristic of a mature industry. In evaluating semiconductors as a potential industry to invest in, irrespective of individual company prospects, there are several key questions to answer:

- 1) *Semiconductor sales are still rising year-over-year despite a declining consumer PC market (what is typically associated with semiconductors). How can we account for this growth?*
- 2) *There are three dominant business models in the semiconductor space (foundry, IDM, and fabless). Which of these business models is best positioned to capitalize on semiconductor trends in the coming years?*
- 3) *China, the country that is responsible for half of semiconductor billings in the entire world, has been experiencing economic headwinds as of late. How does this affect our overall view of the semiconductor market as investors?*

In this section the TMT team will answer these three questions as a way of supporting our view that a fundamentally sound investment in this space will be accompanied with industry-wide and macroeconomic tailwinds. Putting together our granular bottom-up analyses with broader top-down analyses is recipe for a sound investment.

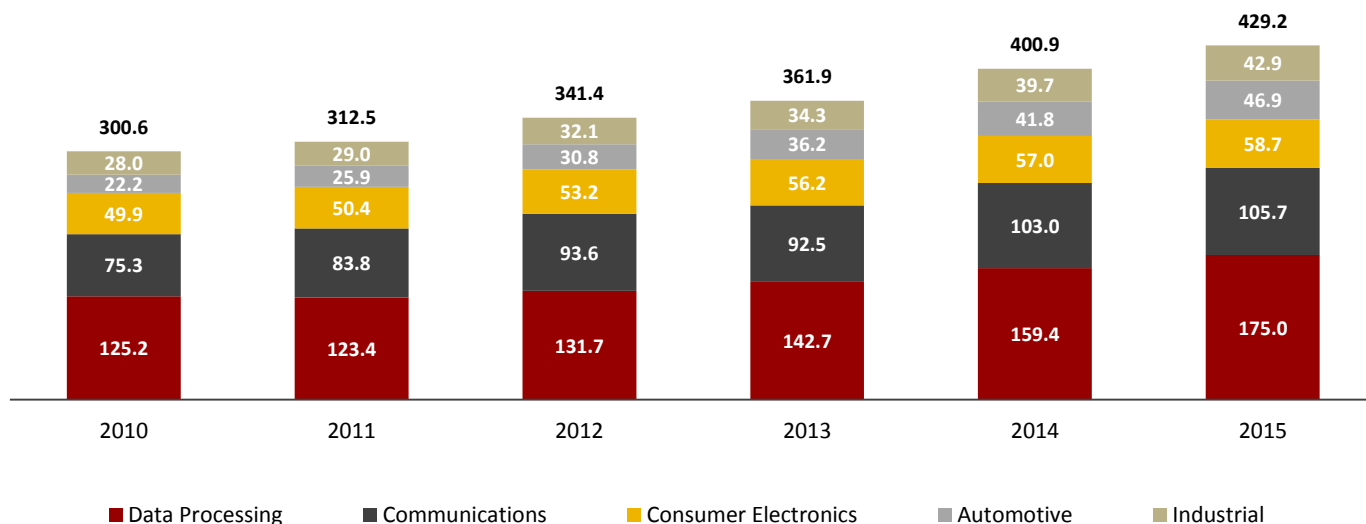
### Old Sector... New Growth

In the past five years, the overall semiconductor market has grown by 7.4% each year. As we expected, when we broke down this growth into individual applications, the majority of growth is coming from the automotive and industrial verticals. The automotive and industrial verticals have grown at 15.8% and 8.9% respectively, compared to consumer electronics which has grown at 3.3% from 2010 to 2015.

The relevance of this trend to DCM is that we believe the market is over-emphasizing the effect of flat-to-declining change in smartphone and PC sales on semiconductor companies. With the advent of trends like the Internet of Things (e.g. wearables, connected cars), the number of applications for semiconductors continues to grow, despite the fact that legacy applications such as PCs and smartphones have peaked.

If we zoom in on the automotive vertical in particular, this case is particularly interesting. As semiconductors in vehicles is in the early stages of adoption, the 15.8% growth figure seems fitting and not overly exciting.

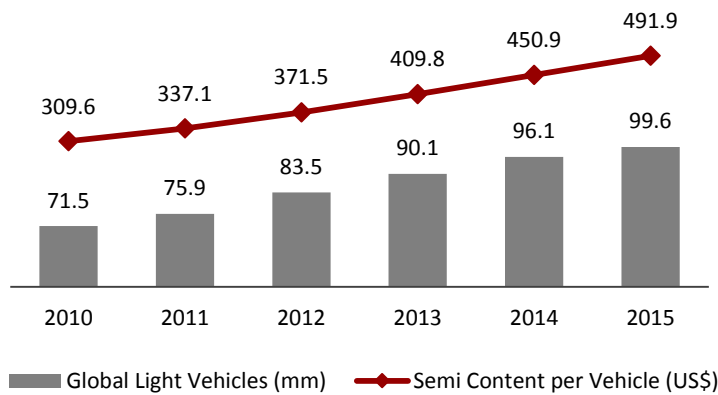
**Figure 14: Semiconductor Growth Now Driven By Auto & Industrials**



Source: IBISWorld Industry Report, PwC, Statista

## 2016 Outlook and Sector Strategy

**Figure 15: Vehicle Sales and IT/Vehicle Both Driving Auto Growth**



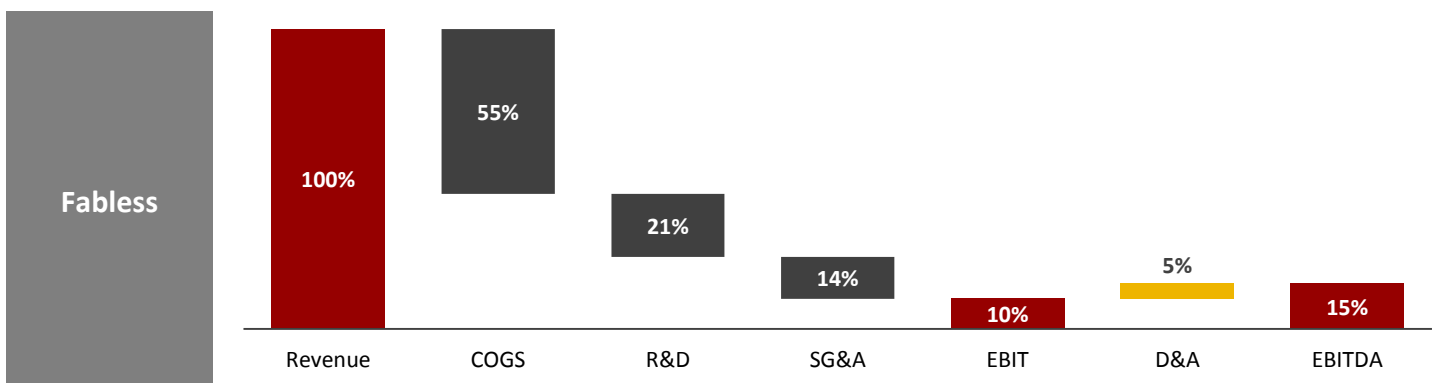
However, DCM believes that the market is missing that the growth in the automotive vertical is not linear in nature. As a case study, the BRIC countries' automotive market exemplifies this concept. The idea here is that not only are the number of vehicles growing rapidly, but the number of semiconductors per vehicle is also increasing. This creates a magnifying effect for the automotive vertical in particular. Other verticals, such as consumer electronics (smartphones in particular), have physical limitations such as space and heat capacity that limit the amount of semiconductors that can be placed on the device. In contrast, the semiconductor concentration in vehicles is so low that this problem is not present.

### Fabs Not So Fabulous Anymore

Over the past decade the semiconductor space has undergone a transformation in terms of the business models that semiconductor companies use. In the past, IDMs, or Integrated Device Manufacturers, were the generally accepted business model of any semiconductor company. This means that these companies own and operate their own "fabs" (factories used to manufacture semis) and are also responsible for upstream operations, such as R&D, and downstream operations, such as marketing and sales. However, due to the capital requirements of operating a fab and how asset-heavy some of these semiconductor companies can get, the fabless-foundry business model gained traction. Fabless companies do not have factories or plants but rather offload the manufacturing part to third-party manufacturers called foundries. The fabless company is responsible for the research and development to produce the semiconductor and for the sales and marketing of the finished components. However, all the work that requires machinery is performed by the foundries, who do not participate in any other aspect of the semiconductor value chain. This allows fabless companies to turn fixed costs in variable costs and focus on creating superior technology, brand loyalty, and customer relationships rather than worry about operating fabs.

Each of the three business models has its own cost structure that are either positive or negative to investors depending on your view of the semiconductor market.

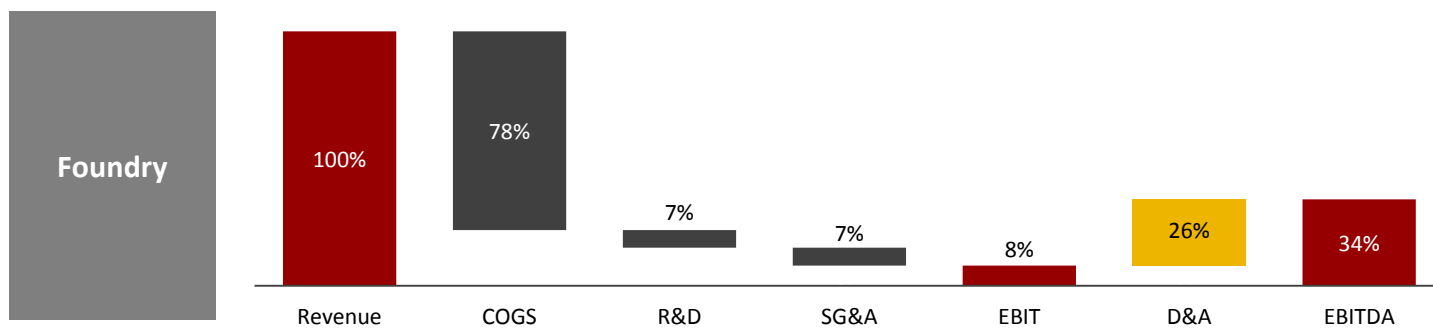
**Figure 16: Fabless Cost Structure & EBITDA Margins**



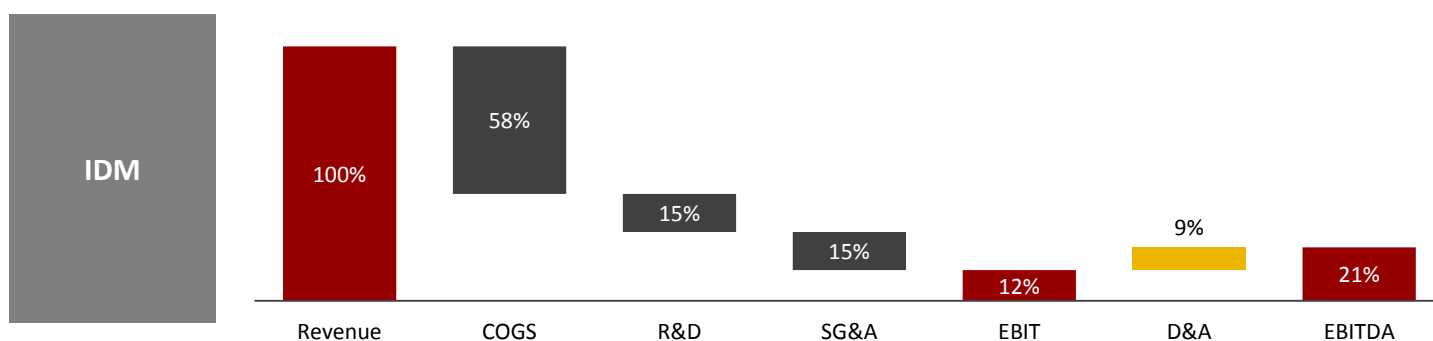
Source: IBISWorld Industry Report, PwC, Statista

## 2016 Outlook and Sector Strategy

**Figure 17: Foundry Cost Structure & EBITDA Margins**



**Figure 18: IDM Cost Structure & EBITDA Margins**



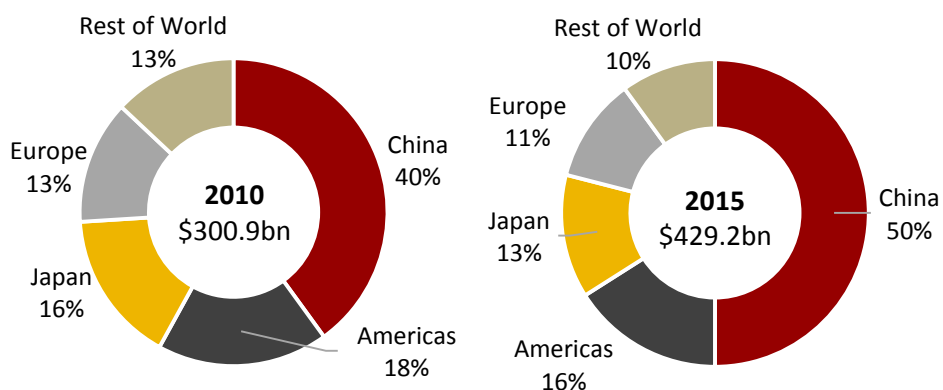
The above analysis was performed by taking the average cost structures of the three largest semiconductor companies within each of the business models from the years 2011 to 2015. The takeaway here is that fabless companies have the lowest D&A and highest R&D and SG&A, whereas foundries have the highest COGS and D&A and lower R&D and SG&A.

To investors, this means that if one believes the semiconductor market is going to experience a downswing, it would be safer to be on the fabless side of the spectrum (variable costs). The TMT team has a view that all else being equal, the IDM model is actually the best positioned. This is because in an upswing, IDMs have access to lower-cost production (they have their own fabs) and will be at peak capacity utilization, but in a downswing, they are not as exposed as foundries are to the aggregate demand in semiconductor manufacturing. In comparison, foundries face compressed margins even in an upswing because of limited competitive advantage and fabless companies face higher costs and less efficient production.

### China: Boom or Bust?

Since the inception of the semiconductor industry, China has grown to become the dominant leader in both consuming and supplying semiconductors. Not only has the overall semiconductor market grown, but China's share of the pie has grown to about half as of 2015.

**Figure 19: Worldwide Semiconductor Billings**



Source: IBISWorld Industry Report, PwC, Statista

## 2016 Outlook and Sector Strategy

More recently China has been experiencing a broad economic slowdown that has cast a shadow over the semiconductor market through 2015. This is evidenced by smartphone shipments to China, which have grown by as little as 1.2% throughout the entire year (far less than expectations). During the latter half of 2014 and most of 2015, many semiconductor companies released sub-par earnings expectations and quoted “swimming in excess inventory” and “prices were falling apart for much of last year” among many others as causes for the poor earnings. These statements are indicative of an industry-wide slowdown, closely linked to China’s economy.

Upon diving deeper into the situation, DCM’s TMT team believes that China’s economic slowdown is a non-issue for the majority of semiconductor companies. The main supporting statistic comes from a Semiconductor Industry Association report released in early January that shows as of year-end October 2015, China was the only region that experienced an increase in semiconductor sales, despite adverse currency effects. On a constant currency basis, the picture is much rosier than initially expected by street analysts and shows semiconductor’s continued resilience as an industry.

### Relevance to Intel

In the above analyses, the questions initially posed have now been answered. However, it is now important to relate our view on the semiconductor industry back to our current semiconductor holding, Intel Corporation (NASDAQ:INTC).

#### 1) Semiconductor growth coming from new applications

Contrary to popular belief, a large portion of Intel’s revenue is not derived from its “Client Computing Group” (consumer PC segment), which declined 8% in 2015 from 2014. Intel’s “Data Center Group” revenue increased 11% in 2015 and its “Internet of Things Group” revenue increased 7% in 2015. This is proof that Intel is successfully diversifying its revenue mix away from the declining consumer PC segment and into higher growth verticals.

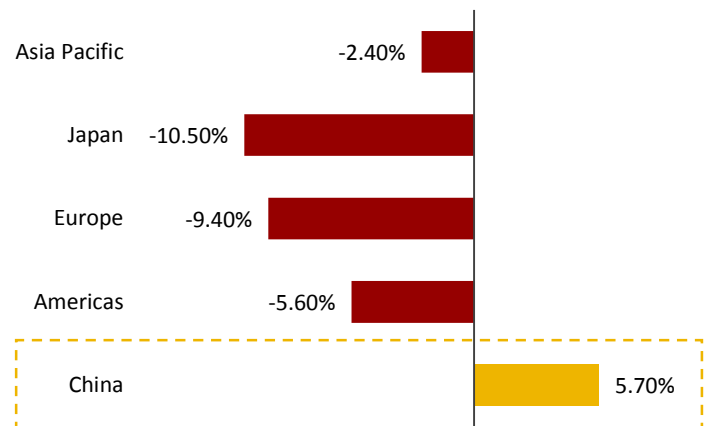
#### 2) Various business models in semiconductor industry

This is self-explanatory – Intel is an Integrated Device Manufacturer and the justification for our opinion that IDM’s are best positioned are above

#### 3) China’s effect on the semiconductor industry

Compared to its competitors, Intel’s revenue is more diversified (only 20.04% from China, with 20.71% from the highest region). Intel engages in substantial hedging activities to reduce exposure to FX changes – this mitigated a lot of FX losses in 2015.

Figure 19: Semiconductor Revenue Change YoY



Source: IBISWorld Industry Report, PwC, Statista

# Technology, Media, & Telecommunications Sector

## Holdings Review



# Intel Corporation (NASDAQ:INTC)

## Company Overview

- Intel designs, manufactures, and sells computer components and related products
- It is the world's largest and highest valued semiconductor chip maker
- Apart from semiconductors, Intel also makes motherboards, network controllers, integrated circuits, flash memory, graphics chips, embedded processors, and other devices related to computing
- Intel's core competencies are its advanced chip design capability, leading-edge manufacturing, and strong R&D pipeline

## Catalysts

- Continued explosive growth of data centers as business models transition to the cloud – (Altera acquisition to strengthen Intel's position in DC)
- In consumer computing, lower than expected PC sales (<1% Y/Y) along with trends such as adoption of NAND and x-point memory will drive revenue growth

## Risks

- Intel is exposed to secular data center trends (~50% of operating profit expected from DCG) despite PC stigma – negative trends like excess capacity will affect Intel
- Mobile segment continues to burn cash and generate losses – if management is unable to reduce expenditures in this segment, will weigh on overall margins

## Financial Summary

### Public Market Overview

Values in \$mm, as of 12/31/2015

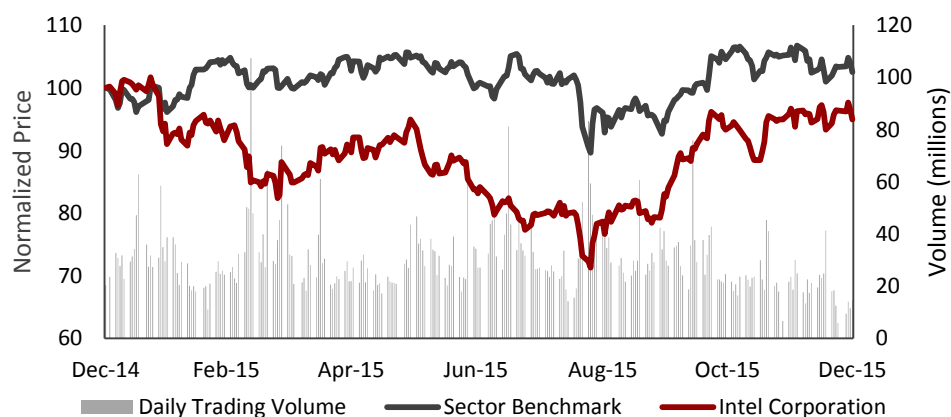
Share Price	\$34.45
S/O (mm)	4,811
<b>Market Cap</b>	<b>165,738</b>
+ Total Debt	20,059
+ Minority Interests	-
+ Preferred Shares	-
- Cash	-21,208
<b>Enterprise Value</b>	<b>164,589</b>
<i>Beta</i>	0.92
<i>Dividend Yield</i>	2.8%
<i>52-Week High</i>	\$37.49
<i>52-Week Low</i>	\$24.87

### Financials & Multiples

Values in \$mm

	LTM	FY2015E	FY2016E
<b>Revenue</b>	<b>55,162</b>	<b>55,249</b>	<b>57,865</b>
% Growth		0%	5%
<b>EBITDA</b>	<b>23,319</b>	<b>22,299</b>	<b>23,973</b>
% Margin	42%	40%	41%
<b>Capex</b>		<b>7,297</b>	<b>9,871</b>
% of Revenue		13%	17%
<i>EV/EBITDA</i>	7.1x	7.4x	6.9x
<i>Price/Earnings</i>	14.8x	15.5x	14.6x

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: Dow Jones US Technology Index.

## Position Snapshot

Average Cost	\$26.03
# of Shares	2,065
Value Invested	\$98,820
Portfolio Weight	3.46%
2015 HPR	13.0%
HP Benchmark Return	22.1%
Excess Return	(9.0%)

## Investment Thesis

### 1. Vertical integration provides competitive advantage

- Intel continues to have the highest EBITDA margin among its peers, showing the superiority of a vertically-integrated supply chain
- Intel’s transition from tick-tock to tick-tock-tock capex model will result in even higher operating leverage in a high fixed-cost market (re-use of PP&E and longer useful life → positive for cash flow)

### 2. “Monopoly” in data center segment

- As the data center generates more operating profit than Intel’s legacy client computing division, investors begin to focus on data center rather than client computing as value driver
- Double digit cash flow growth with sustainable margins due to dominant position in data center industry and moat separating current workload from ARM encroachment

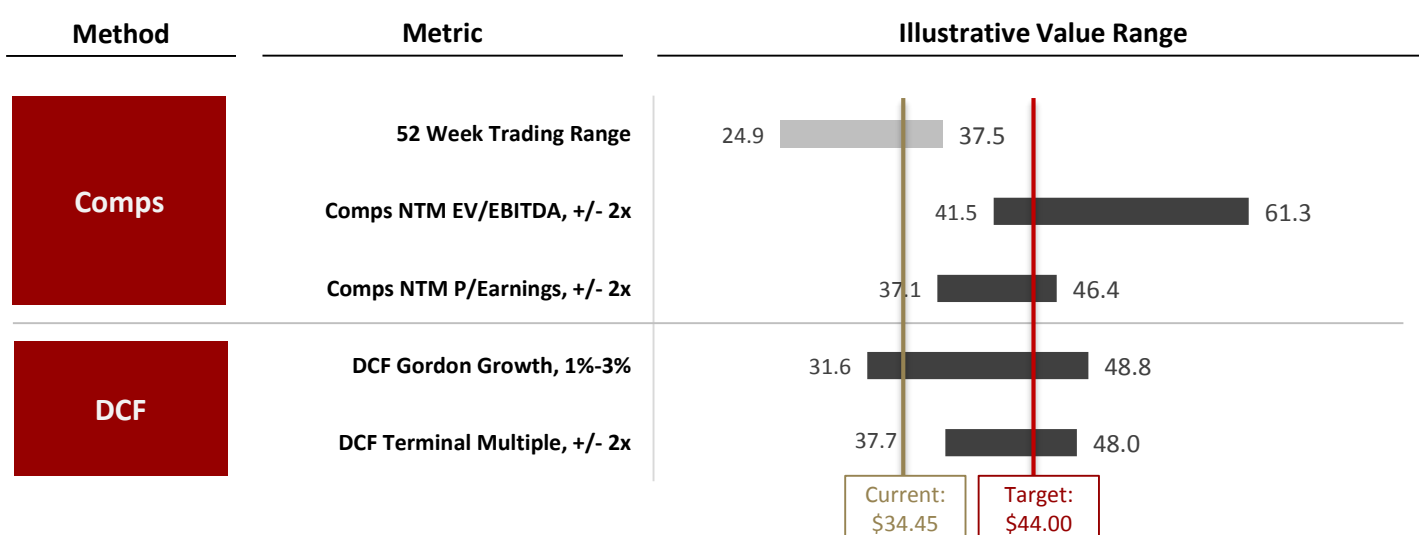
### 3. PC demand risk is priced in

- It has been long known that consumer PCs are a dying industry – management’s 3Q15 guidance implies a ~13% revenue decline Y/Y and analysts have similar estimates
- Optionality from adjacent segments such as IoT, memory, mobile, and M&A opportunities such as Altera will slowly shift Intel’s revenue mix away from PC, all the while maintaining stable cash flow generation (still accounts for >100% of operating profit combined with data center segment)

## Analysis of Performance

Intel is one of our legacy holdings. 2015 was definitely a shaky year for Intel, with more volatility in the stock than seen historically. Intel’s stock is trading at just about where it was at the beginning of the year but the stock was trading as low as \$25 in August. Intel’s stock experienced major dips in January, March, and June, all related to announcements regarding poor PC demand. Management insisted that these figures were transitory and with Skylake and Windows 10 that PC demand would pick up. The stock also reacted negatively to the Intel-Altera deal as Intel paid almost 8x sales. Towards the end of the year, there were a series of positive PC announcements as well as higher-than-expected DCG revenues, leaving Intel’s overall return over the year relatively flat.

## Valuation Summary





# Time Warner Inc. (NYSE: TWX)

## Company Overview

- Time Warner operates media and entertainment assets through 3 main segments (Turner, HBO, Warner Bros.)
- Turner operates several of the largest U.S cable networks including TNT, TBS, Adult Swim, Cartoon Network and CNN
- HBO is the longest running and most profitable premium pay television service
- Warner Brothers is the world's largest television and film studio (based on revenues)
- Time Inc. spun off in 2012 and Time Warner Cable spun out in 2009

## Catalysts

- New online distribution channels drive up content prices benefiting all divisions
- HBO NOW gains significant online market share without cannibalizing existing sales
- Recent success in the gaming sector (Top US publisher) proves to be sustainable
- Lack of acceleration in subscriber declines

## Risks

- Subscriber declines accelerate, which project a dim future for the traditional cable business
- Rapid shift of ad dollars away from television towards desktop and mobile platforms reduces profitability at Turner

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

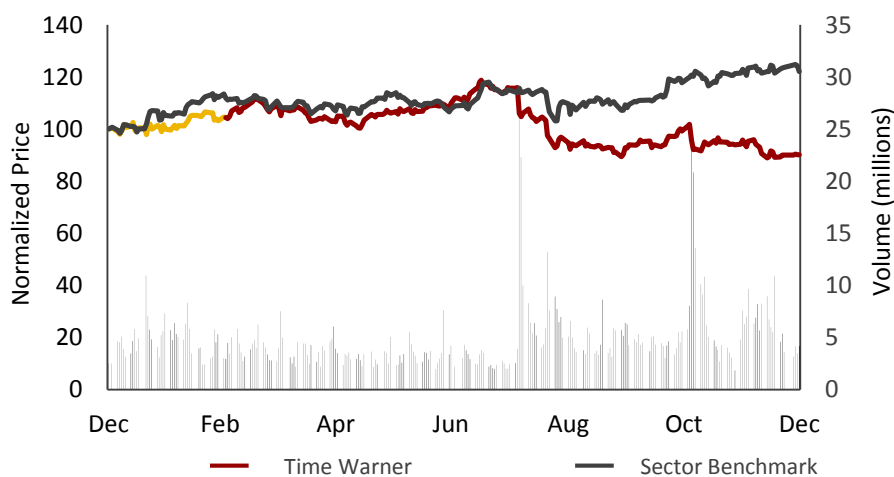
Share Price	\$64.67
S/O (mm)	799.5
<b>Market Cap.</b>	<b>\$51,702.4</b>
+ Total Debt	\$22,927
+ Minority Interest	\$29
+ Preferred Shares	\$0
- Cash	\$1,774
<b>Enterprise Value</b>	<b>\$72,884.4</b>
Beta (1-Year)	1.40
Dividend Yield	2.0%
52-Week High	\$91.01
52-Week Low	\$63.41

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$28,564	\$30,043	\$31,731
% Growth		5%	6%
EBITDA	\$8,020	\$8,389	\$9,042
% Margin		28%	28%
EPS	\$4.43	\$5.27	\$6.11
% Growth		19%	16%
EV/EBITDA	9.1x	8.7x	8.1x
P/E	14.6x	12.3x	10.6x

## Market Performance



## Position Snapshot

Average Cost	\$101.37
# of Shares	1,350
Value Invested	\$121,275
Portfolio Weight	4.25%
2015 HPR	-13.7%
HP Benchmark Return	9.1%
Excess Return	(22.8%)

All figures in CAD

Benchmark: DCM Technology & Media Index

# Time Warner Inc. (NYSE: TWX)

## Investment Thesis

- 1. Large media players to benefit from industry headwinds:** Time Warner is strongly positioned in an environment where affiliate fees are shifting increasingly towards premium content.
  - Time Warner’s content portfolio is skewed towards premium content (they own 3 of the top 10 cable networks) and should benefit from expected double-digit growth in subscription fees
  - The company is less exposed to decline in advertising compared to core peers (lowest as a percentage of revenue and EBITDA)
- 2. Strategic Content and HBO OTT:** The one-two punch of having the largest content portfolio in the industry and a new innovative means to distribute this content positions Time Warner in the forefront of media creation and distribution
  - HBO NOW reached 1 mm subscribers by the end of Q2, greatly surpassing our previous estimates. HBO NOW is similar to Netflix and its success could lead to multiple expansion
- 3. Attractive Valuation:** Trades at discount to peers of EV/EBITDA basis and our DCF yields 55% upside
  - The market has neglected sequential positive earnings releases due to industry skepticism

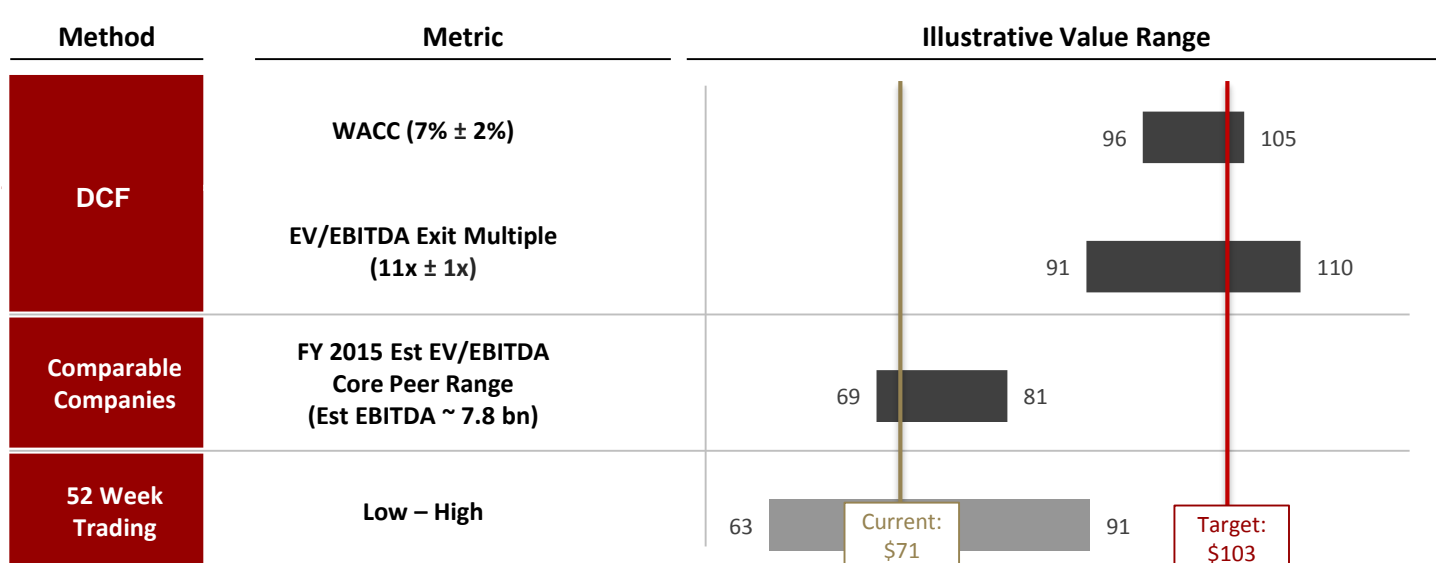
## Analysis of Performance

Over the past year, Time Warner has performed poorly and is down almost 20%. While the company outperformed the S&P 500 for most of the year, TWX declined considerably this summer after an industry wide sell-off.

In our opinion, the sell-off was unwarranted for several reasons. Firstly, the reason why many companies have lowered their cable guidance is not solely due to poor performance, but rather FX headwinds. Second, while ratings did decline, the rating systems are antiquated and in some cases do not take into account increases in online viewership. In summary, we don’t believe that the information that caused the sell-off invalidates our original thesis. We think Time Warner is well positioned to deal with tailwinds in the media industry and that market discounts the potential of a successful transition to online media.

We took the downturn as an opportunity, and increased our position after the sell-off. While we are confident in our position, the main risk is a rapid decline in subscribers at Turner. Going forward, we will closely follow this metric (subscriber levels).

## Valuation Summary



# Cogent Communications (NASDAQ: CCOI)

## Company Overview

- Cogent is a leading global provider of dedicated internet access
- Their network carries ~ 20% of global internet traffic
- Cogent's unique business model focuses on becoming a low-cost “dumb pipe” to gain market share for large incumbent players
- Cogent operates in two-segments: Corporate and Net-Centric
- Corporate mainly focuses on providing fiber-based internet services to corporates customers in high-rise buildings
- Net-centric primarily focuses on selling internet transit to smaller networks

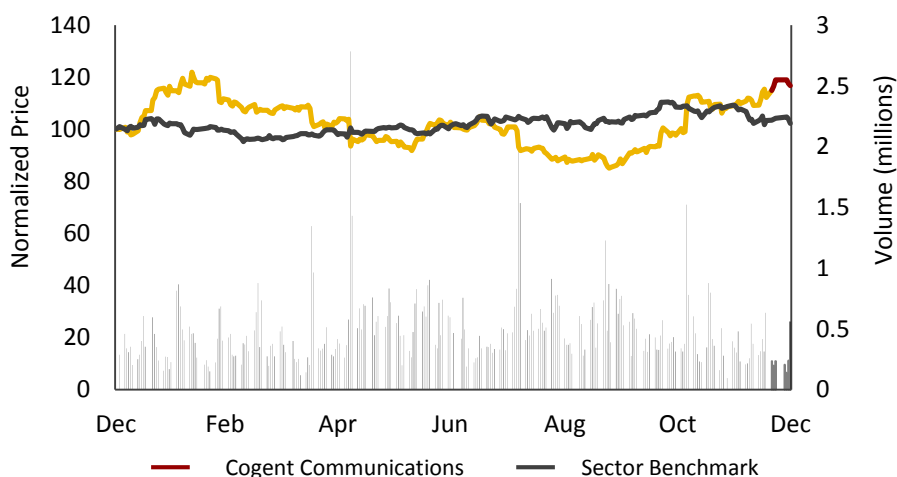
## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

Share Price	\$34.69
S/O (mm)	45.2
<b>Market Cap.</b>	<b>\$1,567.5</b>
+ Total Debt	\$581
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$207
<b>Enterprise Value</b>	<b>\$1,941.1</b>
Beta (1-Year)	0.95
Dividend Yield	4.9%
52-Week High	\$39.89
52-Week Low	\$26.16

## Market Performance



Benchmark: DCM Telecom Index

## Catalysts

- Historical growth in net-centric segments returns due to settlement of interconnection disputes
- Telco lobbying efforts to repeal net neutrality rulings do not bear any fruit
- Corporate demand for data heavy services increases demand for CCOI's more expensive gigabit Ethernet service

## Risks

- Interconnection settlements are slow to resolve, and earnings do not improve in the short-term
- Reduction in dividend reduces attractiveness of CCOI to some investors (perhaps due to unexpected CAPEX or inability to raise debt)

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$396	\$446	\$491
% Growth		13%	10%
EBITDA	\$112	\$151	\$174
% Margin		34%	35%
EPS	-\$0.01	\$0.48	\$0.87
% Growth		-8179%	83%
EV/EBITDA	17.3x	12.9x	11.2x
P/E	-5879.7x	72.8x	39.8x

## Position Snapshot

Average Cost	\$45.21
# of Shares	1,830
Value Invested	\$88,184
Portfolio Weight	3.09%
2015 HPR	1.6%
HP Benchmark Return	-1.2%
Excess Return	2.9%

All figures in CAD

# Cogent Communications (NASDAQ: CCOI)

## Investment Thesis

- 1. Interconnection settlements:** Growth in the net-centric segment will return as interconnection points receive necessary capacity upgrades
  - Open Internet ruling in February 2015 should put an end to interconnection disputes
  - Cogent recently struck an interconnection agreement with CenturyLink in late November
- 2. Growth in Data Heavy Services:** Consumer shift towards online video will greatly increase global web traffic. In addition, corporate demand for high bandwidth-intensive applications will increase demand for Cogent’s 100 Mbps service
  - 4K television sales were up over 600% in 2014
  - Netflix appears to be releasing more and more of their original content in 4K (Daredevil, Narcos, Jessica Jones)
  - Growth in corporate web-based services should accelerate transition to Cogent’s high speed service
- 3. Reduction in Capital Intensity:** Capital spending will slow down as Cogent reaches all of its target countries and buildings
- 4. Attractive Valuation:** Our DCF yields a 15% percent up despite recent appreciation.
  - Rare double of being both a growth (~10% top line) and yield stock (~4%)

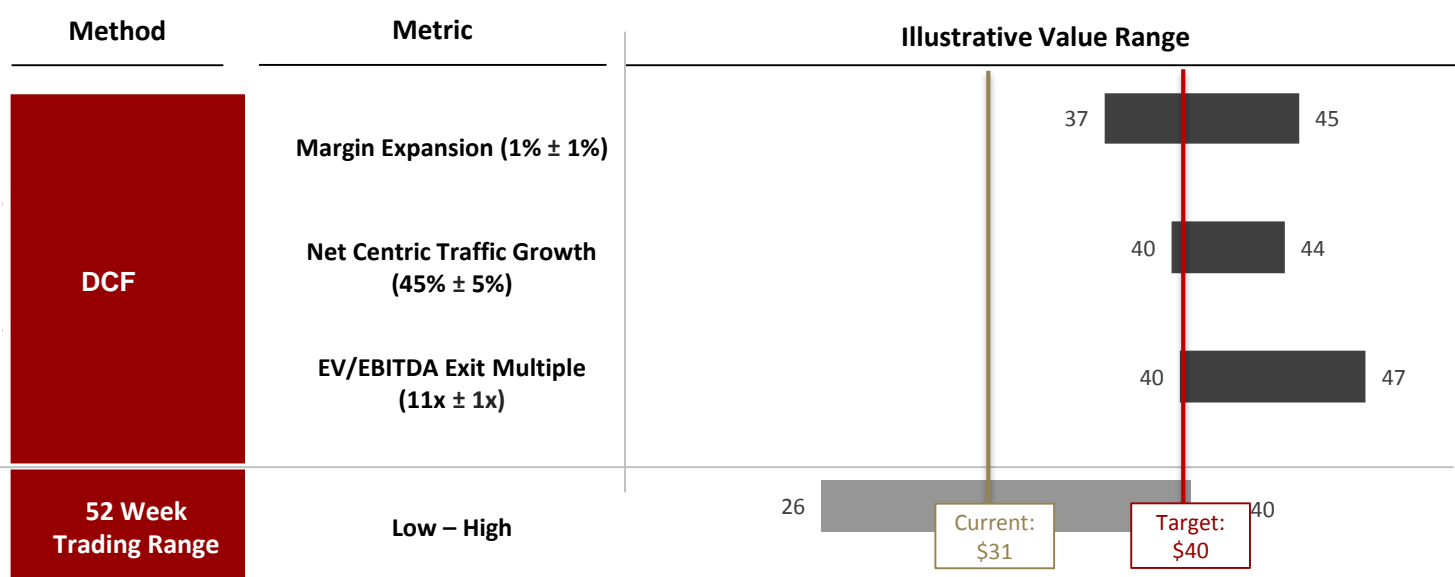
## Analysis of Performance

Cogent was a having a disappointing year until the stock jumped 20% after a positive earnings release. The most recent release appears to have confirmed suspicions that the company’s poor performance over the past year was indeed the result of interconnection disputes.

While we were thinking about CCOI prior to the release, we unfortunately did not initiate our position until after the positive news was announced. Nonetheless, our DCF still yields 15% based on conservative assumptions and we believe the stock will continue to rise as more interconnection disputes are settled.

Cogent is one of the fund’s most recent purchases, and the stock has not moved materially since our acquisition.

## Valuation Summary



# Consumers Sector

2015 Review & 2016 Outlook

*By Christie Wei, Michael Saskin, Lambert Lefebvre and Adam Cappabianca*

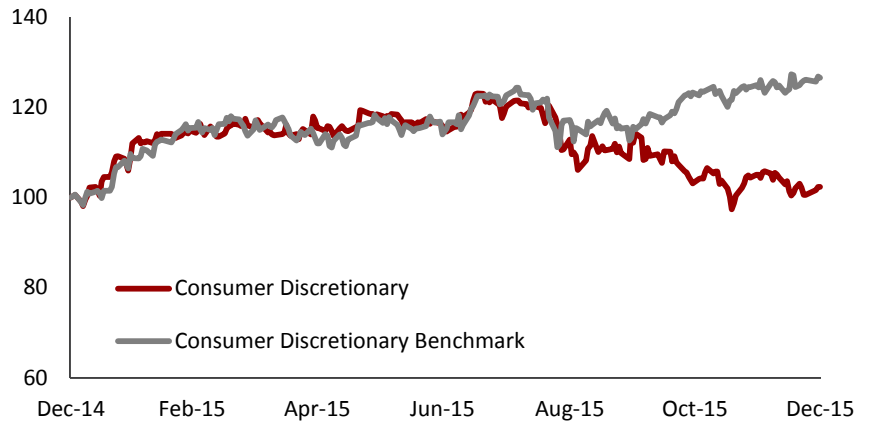


# Consumer Discretionary

## Sector Performance

The DCM Consumer Discretionary sector realized a 2% return in 2015 compared to 24.5% for the sector benchmark. Our consumer discretionary holdings going into 2015 consisted primarily of consumer retail-focused companies: Performance Sports Group (TSX:PSG); TJX Companies (NYSE:TJX); and Amazon.com (NASDAQ:AMZN). Our underperformance can largely be attributed to Performance Sports Groups, our biggest underperformer of 2014 that floundered this year (down 48.2%), due to unfavourable foreign exchange exposure to the rising US dollar in terms of both USD denominated debt and costs.

Figure 1: DCM Consumer Discretionary Performance



On a subsector level, we positioned ourselves well for 2015 given that the S&P 500 Retailing Index had the highest returns this year at 24.3% versus the S&P 500 Consumer Discretionary Index return of 3.8% (Figure 3). Retailing's outperformance can be attributed to stellar returns from e-commerce companies such as Netflix, Amazon, and Expedia, which returned 134.4%, 117.8% and 46.8%, respectively. As such, Amazon.com (NASDAQ:AMZN) was our strongest outperformer in 2015, generating an 83% return over our half-year holding period.

Discount-focused retailers also delivered strong returns, such as Ross Stores and Dollar Tree. Given this, our holding, TJX Companies' (NYSE:TJX) off-price retailer business model continued to be successful in 2015, showing strong same store sales growth as well as investment in new stores. Although TJX returned only 4.6% on a US dollar basis, it vastly outperformed department store retailers such as Nordstrom, Urban Outfitters, and Macy's, which saw double-digit declines and were the biggest losers in the retailing index. While PSG dragged down our 2015 performance substantially, going forward, declining oil prices coupled with increasing personal income should be a tailwind to both PSG and TJX in 2016.

Figure 2: Discretionary Subsector EV/EBITDA

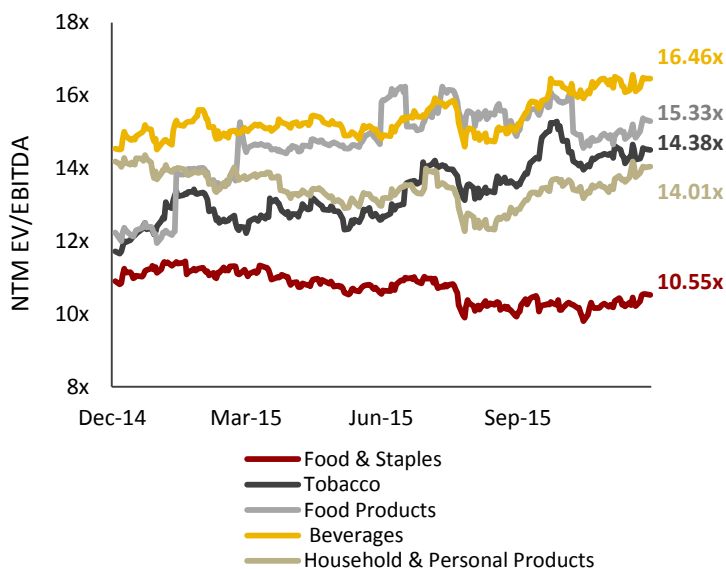
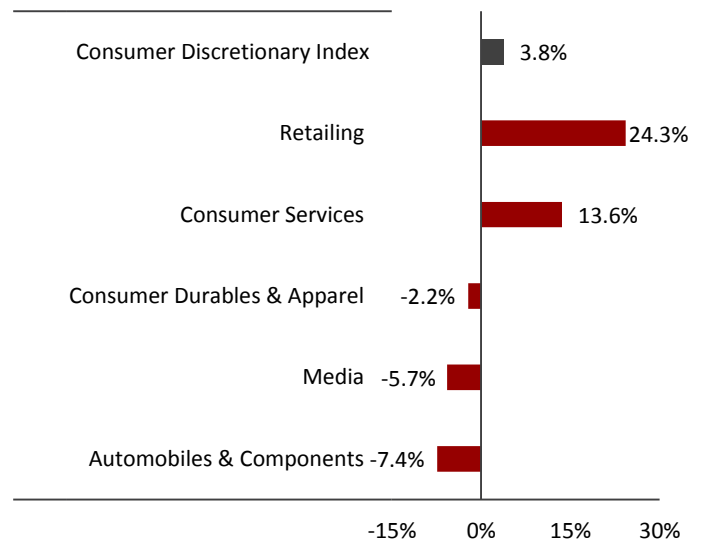


Figure 3: Consumer Disc. Subsector 2015 Returns



Source: Bloomberg, S&P Capital IQ

# Consumer Staples

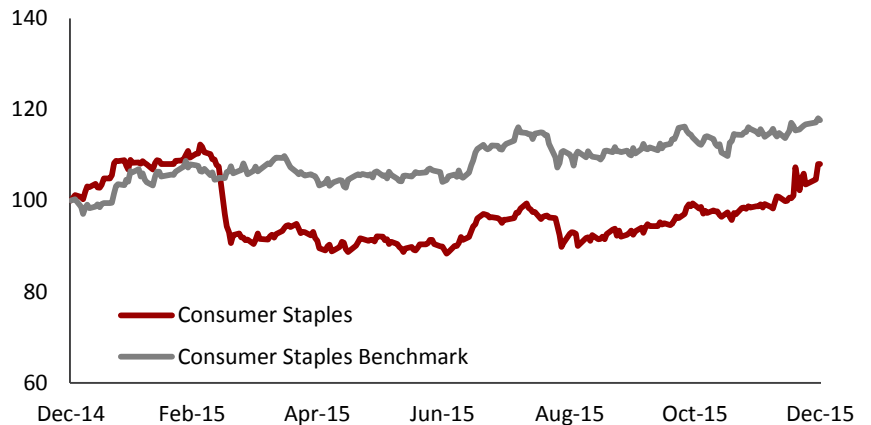
## Sector Performance

Over the past year, the Consumer Staples sector blended benchmark realized an annual return of 15.4%, while our Consumer Staples allocation returned 7.4%. Last year, we anticipated that Consumer Staples would underperform Consumer Discretionary due to our bullish views on the US economic recovery, and thus rotated away from non-cyclical towards cyclical sectors. DCM's Staples sector holdings going into 2015 consisted of Colabor Group (TSX:GCL), which was the main contributor to our underperformance, and a US Consumer Staples ETF. In general, we use the ETF as a placeholder until we find attractive individual names in which to invest. On a subsector level, returns were led by the tobacco products subsector, followed closely by food and staples producers and retailers (Figure 6). Overall, returns in the sector were boosted by near-record levels of M&A activity in the consumer beverages and food products space, as large companies sought profit growth in a mature industry, boosting valuations (Figure 5). For instance, in the global packed food space, pending, proposed, and completed deal volume was \$101 billion, the highest volume since 2007.

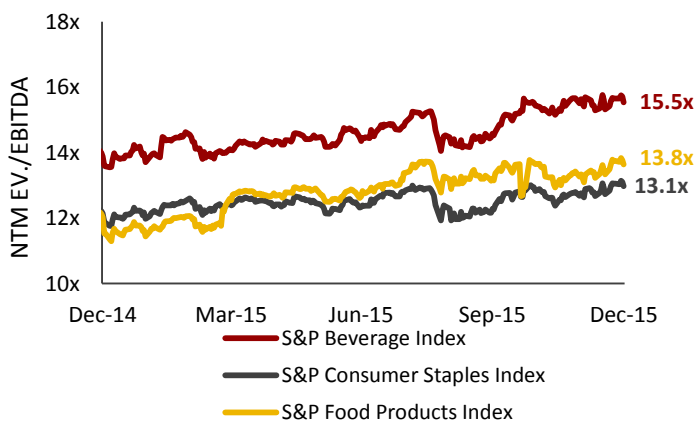
Unfortunately, our position in Colabor, a small-cap Quebec-based food products wholesaler, did not benefit from the increase in valuation multiples seen by large-cap peers, and struggled with increased industry competition. We decided to close our position in Colabor at the beginning of the semester. The company underperformed our benchmark due to debt overhang concerns, along with overestimated turnaround prospects based on new management changes. While this proved to be an unfortunate learning experience, cutting our losses proved to be the right decision as the stock declined an additional 12% after we exited the position.

In December, we initiated a position in Ten Peaks Coffee Company Inc. (TSX:TPK), a leading micro-cap specialty coffee decaffeinator based in British Columbia. Ten Peaks is a premium player that demonstrates strong monopolistic features in a growing market that trades at a significant discount to other high-growth consumer plays. Looking ahead, we will continue to look for great value investments and anticipate rotating out of the sector ETF and into individual names as opportunities present themselves.

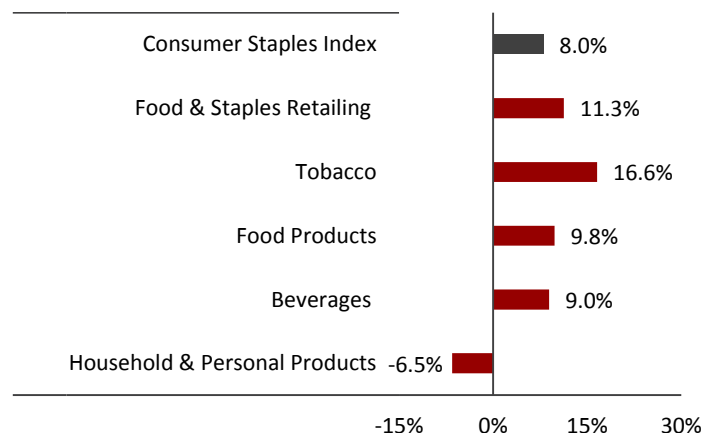
**Figure 4: DCM Consumer Staples Performance**



**Figure 5: Staples Subsector EV/EBITDA**



**Figure 6: Consumer Staples Subsector Returns**



Source: Bloomberg, S&P Capital IQ

## Consumer Discretionary

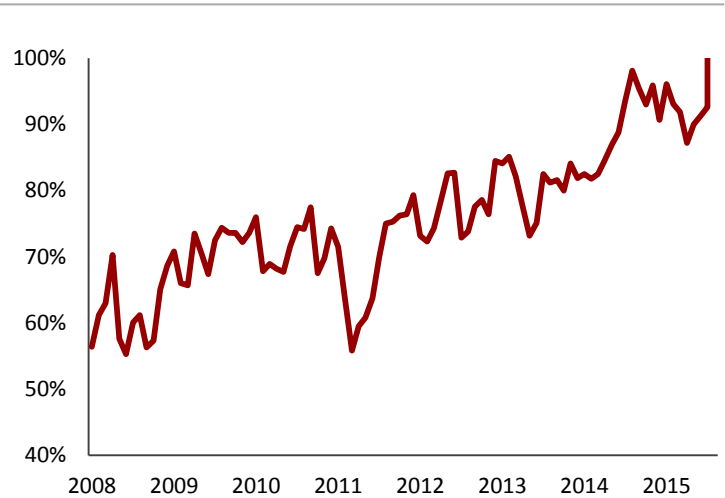
For 2016, we expect to see a continued increase in consumer spending, driven by depressed gasoline prices, a robust job recovery, increasing wages, and record low borrowing costs. With historically low levels of household leverage in the US, coupled with higher disposable income, increased investments in durable goods is expected to continue along with the continued strength in the US housing market. Despite our bullish outlook, we remain cautious of the rising equity valuations, market volatility, and the weight of increasing interest rates on consumer credit.

Falling energy prices have generated savings of approximately \$700 per household (U.S. Energy Information Administration). According to a J.P. Morgan report, roughly 80% of the savings from lower gas prices are spent and not saved. This spending is mostly comprised of non-durable goods and services. The effect of declining gas prices is amplified by steadily increasing disposable income. As a result, consumer sentiment continues to increase and it is at its post-recession peak, as shown in Figure 7.

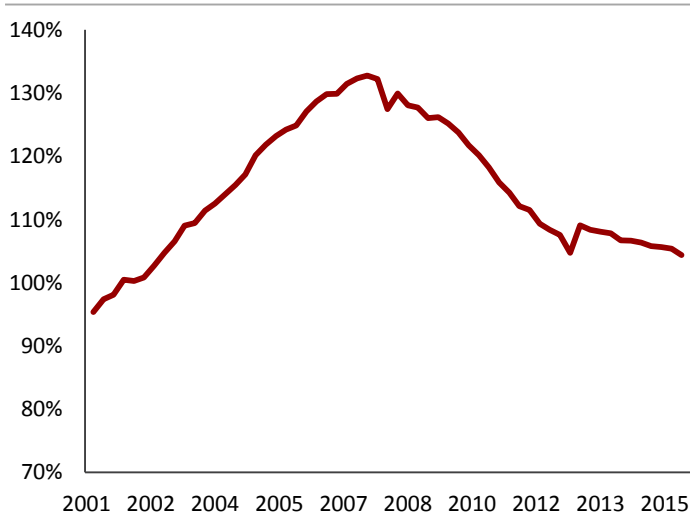
US household debt as a percentage of disposable income has decreased from 132% (in 2008) to 100%, a level last seen in 2002. We believe this provides ample room for consumers to make large ticket purchases through deferred investments, supporting our positive stance on subsectors such as household appliances.

Although we are bullish on the sector in 2016, certain headwinds remain. Firstly, continued rate hikes could negatively impact the housing recovery. Secondly, rising food prices threaten to reduce consumers' disposable income, which would negatively impact consumer spending. Thirdly, escalating geopolitical tensions in the Middle East and Russia threaten to cause a negative oil supply shock, which would increase gasoline prices and reduce consumer spending power. Despite these factors, we continue to remain bullish in the US consumer discretionary space as it is relatively insulated from global risks, vis-à-vis other sectors such as energy or materials.

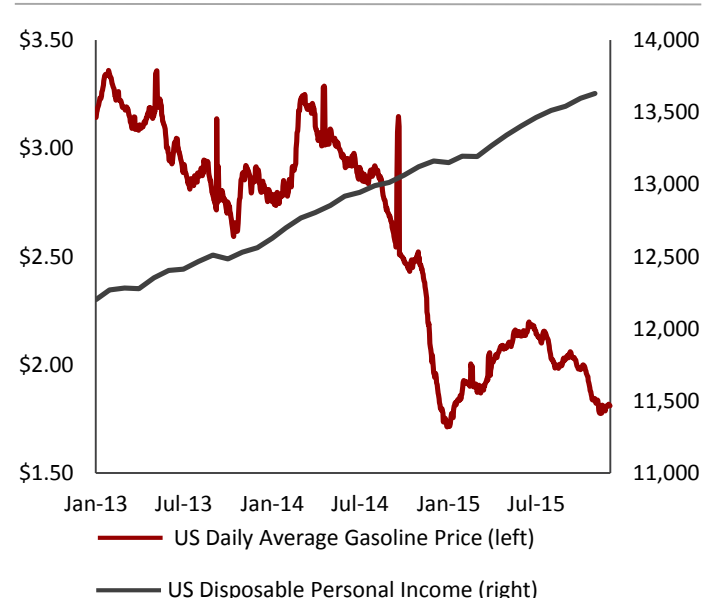
**Figure 7: Consumer Sentiment Index**



**Figure 8: Household Debt-to-Disposable Income**



**Figure 9: Gas Prices vs. Disposable Income**



Source: Bloomberg



## Consumer Discretionary

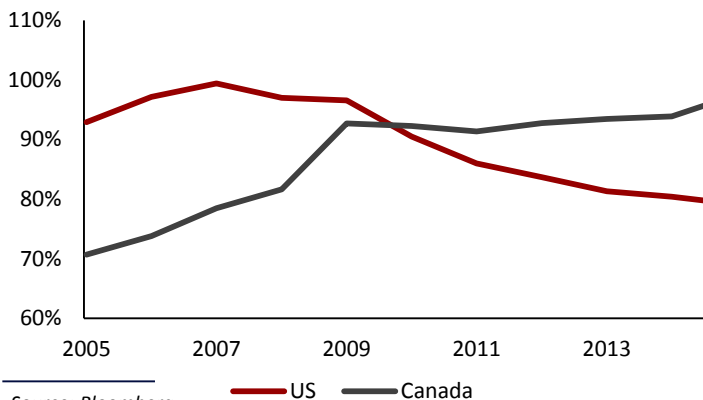
In addition to our general outlook we have identified a number of trends that will impact the industry in the coming years. The first trend we see is the continuing divergence between US and Canadian household debt as a percentage of GDP, as seen in Figure 10. With oil prices expected to remain depressed, we anticipate the divergence to persist as the US economy benefits from low oil prices while Canada has greater negative exposure.

We thus remain more bullish on the US discretionary consumer sector in general; however will continue to look for attractive Canadian equities. However, we also note that these stronger economic fundamentals in the US. will drive a stronger US dollar, which should weigh on select retailers by pushing down tourism-driven sales, especially in the apparel and luxury goods sectors. Translation of foreign sales into US dollar terms will also put pressure on international companies' revenues earned abroad. Thus, we will remain selective within the US discretionary space and especially cautious when looking at the textiles, apparel and luxury goods space or at companies that are earning a significant percentage of revenues in foreign currency.

Another trend that has accelerated in 2015 and should continue to gain momentum in 2016 is the trend towards online sales and e-commerce shopping, as seen in figure 6. Department stores, which have been the traditional distribution channel for large apparel retailers, have been losing market share to other retail channels such as e-commerce in the past decade, as seen by negative median same store sales in Q3 of 2015 (Figure 13). Thus we prefer retailers that have strong online platforms to complement their brick and mortar stores.

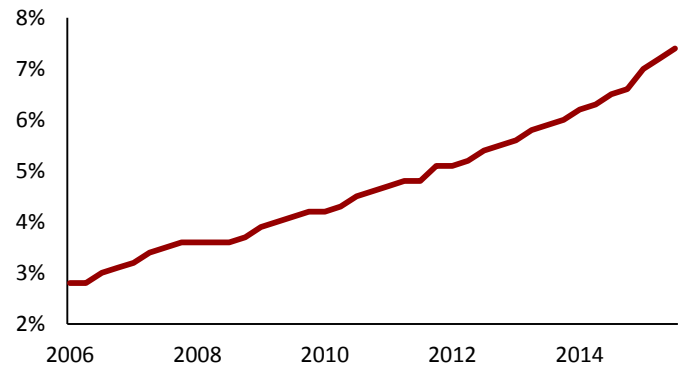
Another development to be cautious of is the build-up of inventory going into 2016 for some retailers. This inventory build-up could lead to deeper-than-expected discounting going into 2016, putting additional margin pressure on an already aggressively discount driven retail environment. Increasing online retailing has also intensified retail competition and the discounting environment by allowing consumers to easily compare prices. Overall, although consumer spending may be demonstrating improvement, this does not necessarily translate positively to all retailers.

**Figure 10: US vs. CAD Household Debt-to-GDP**



Source: Bloomberg

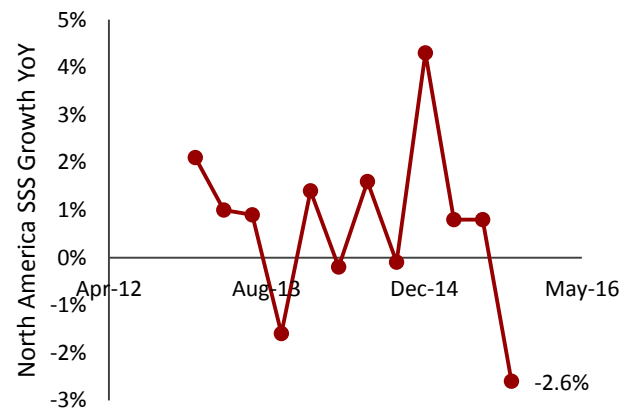
**Figure 11: Online Retail Sales as % of total**



**Figure 12: US Wage Growth % YoY**



**Figure 13: Department Stores SSS Growth**

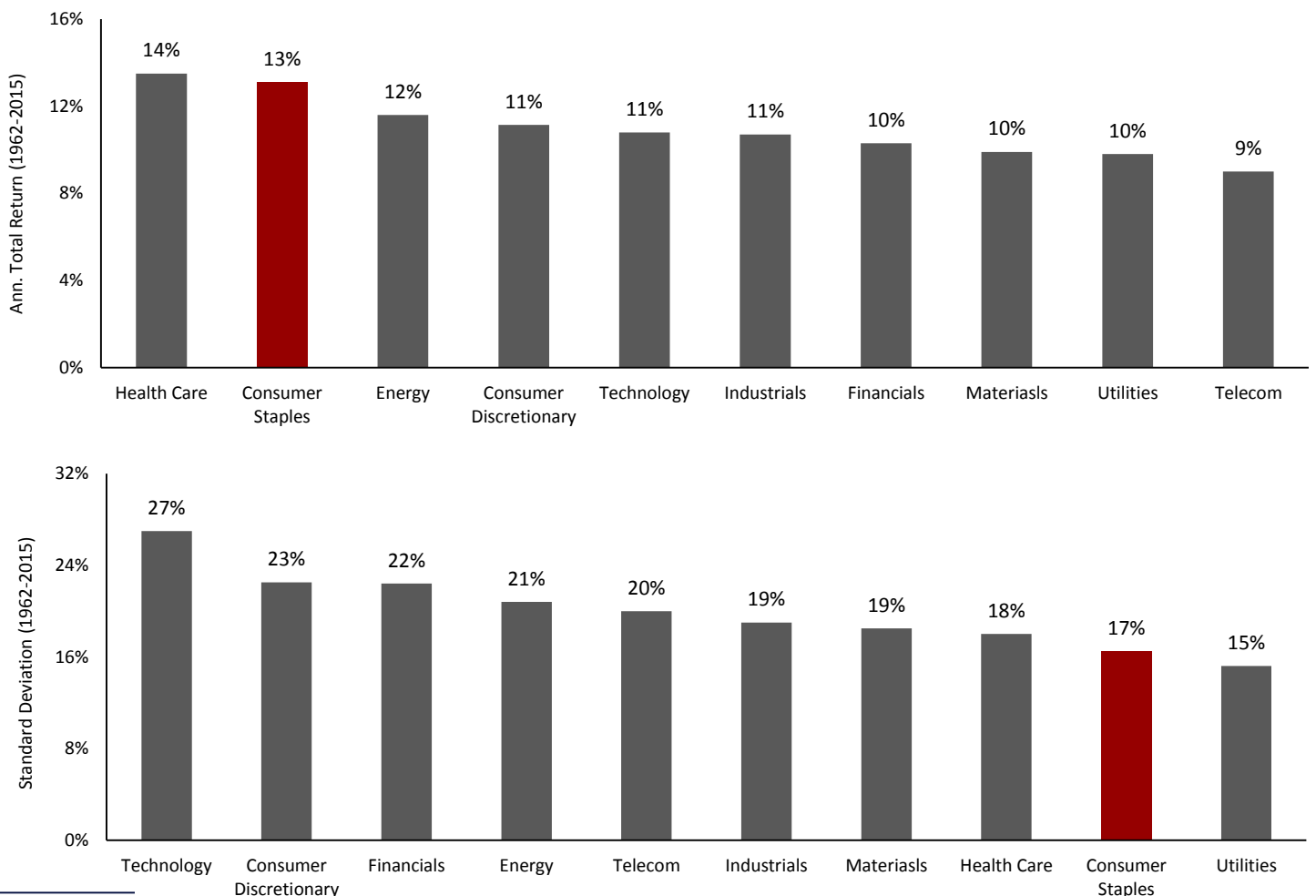


## Consumer Staples

Moving forward, similar to the discretionary sector, staples will continue to benefit from the moderate economic recovery, better job prospects, rising wages and renewed optimism as a result of the housing recovery. However, considering our bullish view on the US. economy, just like in our 2015 outlook, we believe staples will continue to lag discretionary. Interestingly, as interest rates increase, we expect to see a move of capital towards sectors such as staples that act as bond-proxies due to their relatively high dividend yields, and should thus provide a place for investors to park their money during the rate hike to protect against any bond price decrease. Furthermore, as the rate hike is expected to be very gradual by increments of small basis points, we do not expect a move out of the staples subsector within the year to come. Historically, we also note that the consumer staples sector has historically provided the highest annualized total return for its standard deviation (figure 14). On the whole, we therefore do not expect to significantly overweight or underweight the staples sector in 2016, but will continue to look for attractive buying opportunities.

Another positive for staples in 2016 will likely be continued M&A activity, led by strategic buyers. In particular, we anticipate takeover activity from North American buyers looking to gain access to Asian markets, larger companies acquiring strong, smaller brands in favorable niches such as natural foods, and companies simply looking for larger scale to reduce per unit costs. Indeed, cost-cutting in general will likely continue in 2016, with cash savings fueling even more potential M&A activity.

**Figure 14: Staples sector has historically delivered 2<sup>nd</sup> highest return with 2<sup>nd</sup> lowest volatility**



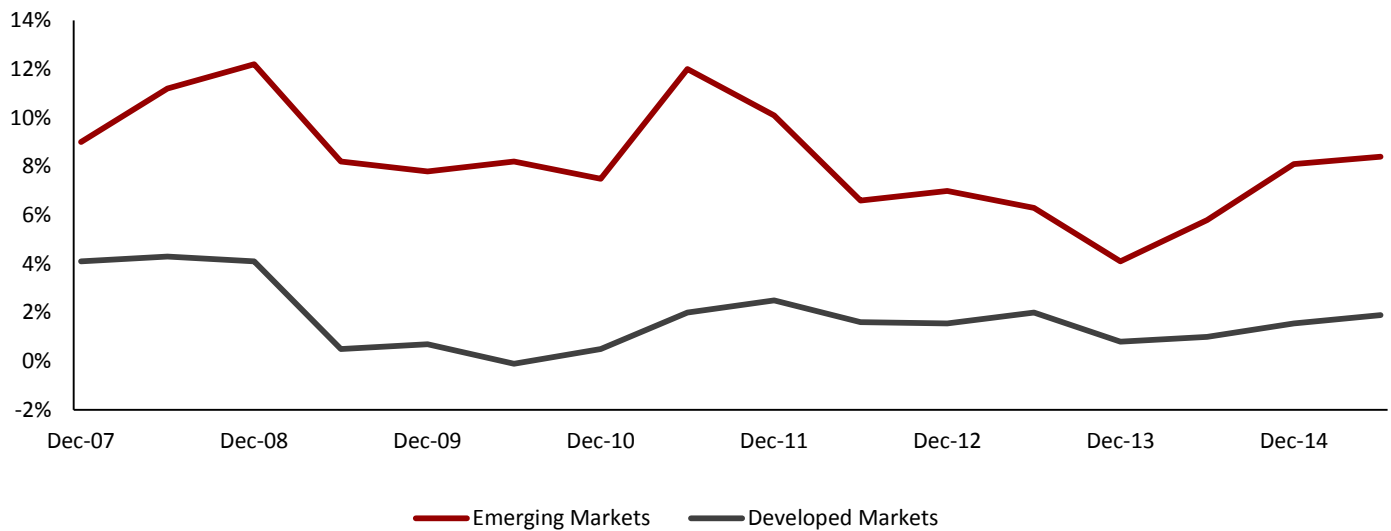
Source: Fidelity Investment Report

## Consumer Staples

Additionally, another trend for 2016 will be the mixed impact of lower commodity prices. While the agricultural landscape has performed poorly since 2011, with the DBA Agriculture ETF index down 48% from its 2010 peak, we see this as a potential discount and will look for attractive discounted opportunities in the subsector. Furthermore, the lower commodities prices in the sector as a whole will improve profit margins for multiple staple subsectors through lower manufacturing input, packaging cost and transportation cost. Specifically, glass used by spirits companies, aluminum used for beverage companies, grain for cereal companies, and crude oil for plastic bottles will all benefit from expanding margins, and we will look for companies benefiting from this trend.

Lastly, similar to the discretionary sector, the continued strength of the US. dollar relative to most foreign currencies will continue to be a near term headwind for US. earnings, while the depreciation of the Canadian dollar will create a bias towards exporting Canadian companies, especially when taking into consideration the continued sales growth of emerging markets in comparison to developed markets (Figure 15) and our current overweight in the US.

**Figure 15: Global YoY Staples Sales Growth Rate**



Source: Bloomberg

# Consumers Sector

Holdings Review



# The TJX Companies Inc. (NYSE: TJX)

## Company Overview

- The TJX Companies, Inc. operates as an off-price apparel and home fashions retailer in the United States and internationally
- TJX offers a wide selection of name brand and designer apparel, accessories, footwear, and home fashions for the entire family internationally (off-price business model indicates the company offers these quality brand name items at significantly discounted prices)
- The company operates in four segments: Marmaxx, HomeGoods, TJX Canada, and TJX Europe

## Catalysts

- Differentiation of off-price retail model from full-priced peers store sales can lead to multiple expansion
- Growth across segments and expansion into other markets driving revenue growth

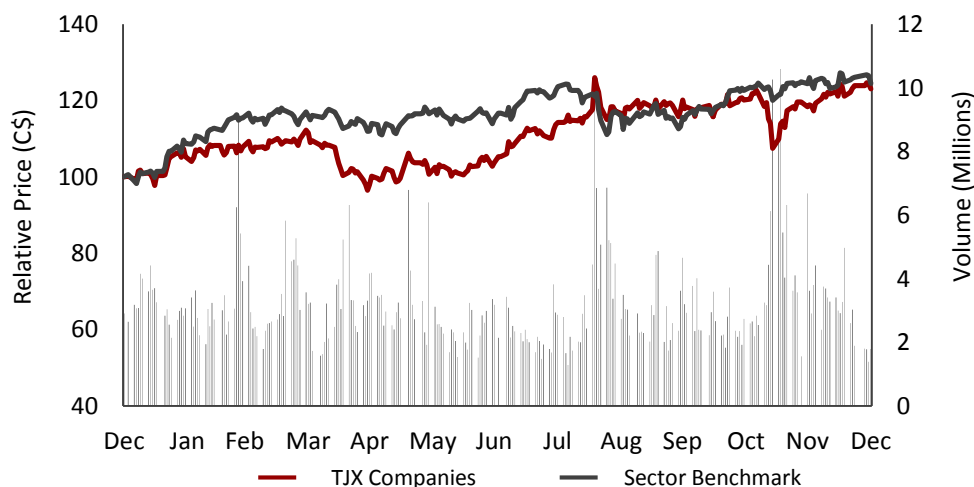
## Risks

- As US wages continue to increase, a consumer shift away from the off-price model towards more expensive products
- Slower than expected European expansion as a result of stagnant economic growth or low brand awareness of TJX

## Financial Summary

Public Market Overview		Financials & Multiples		LTM	FY2016E	FY2017E
<i>(values in \$M, as of Dec. 31, 2015)</i>		<i>(values in \$M)</i>				
Share Price	\$70.91	Revenue		\$30,287	\$30,709	\$32,759
S/O (mm)	669.5	% Growth			1%	7%
<b>Market Cap.</b>	<b>\$47,476.3</b>	EBITDA		\$4,271	\$4,305	\$4,482
+ Total Debt	\$1,624	% Margin			14%	14%
+ Minority Interest	\$0	EPS		\$3.29	\$3.29	\$3.62
+ Preferred Shares	\$0	% Growth			0%	10%
- Cash	\$1,723	EV/EBITDA		11.1x	11.0x	10.6x
<b>Enterprise Value</b>	<b>\$47,377.0</b>	P/E		21.6x	21.6x	19.6x
Beta (1-Year)	0.76					
Dividend Yield	1.2%					
52-Week High	\$76.78					
52-Week Low	\$64.21					

## Market Performance



Benchmark: 100% RXI US Equity.

## Position Snapshot

Average Cost	\$66.15
# of Shares	700
Value Invested	\$68,951
Portfolio Weight	2.42%
2015 HPR	23.1%
HP Benchmark Return	24.5%
Excess Return	(1.4%)

All figures in USD

# The TJX Companies Inc. (NYSE: TJX)

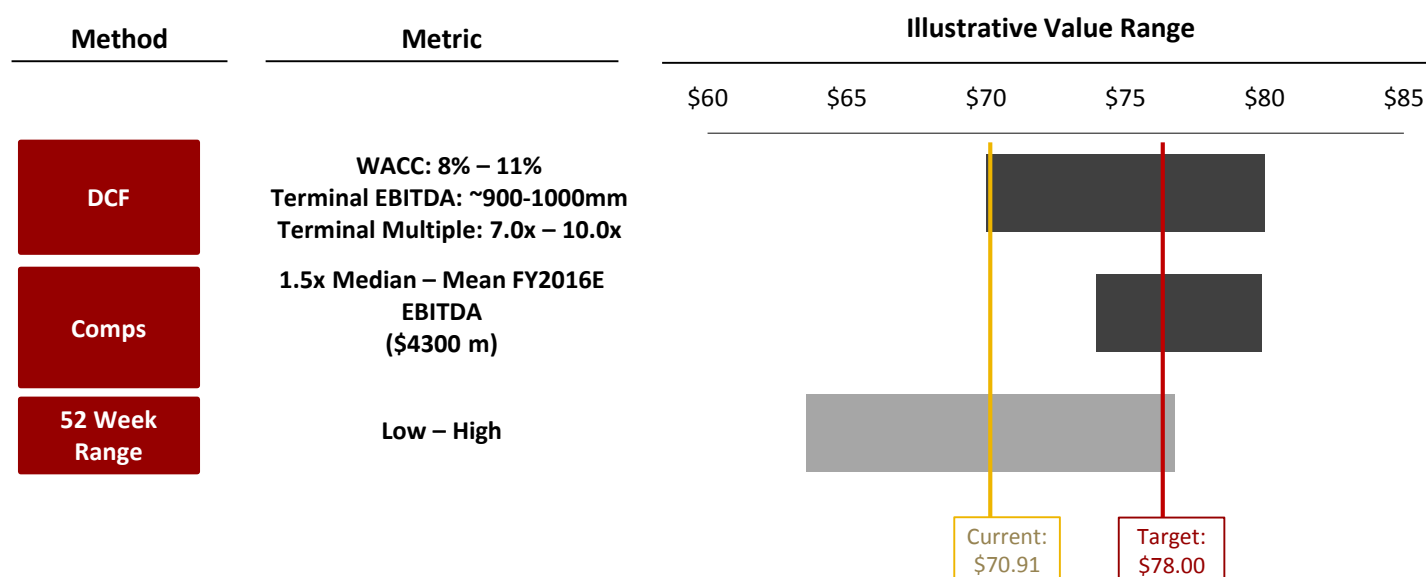
## Investment Thesis

- Growing Target Market:** TJX targets the growing middle class consumer with higher income relative to their competitors
  - The increase in comparable store sales (5% in Q1, 7% in Q2 and 5% in Q3 )demonstrated continued realization of thesis
- Global Buying Organization:** Extensive network that acts as a barrier to entry and allows for superior merchandise, lean inventory and a foundation for expansion
  - Superior sourcing for procurement, allowing for most attractive product offering
  - Growing network of 17,000 vendors in 100+ countries continues to act as a barrier to entry
- Opportunities Among Segments:**
  - Marmaxx:** Continual store remodel program has led to increased consumer traffic and number of units sold, which has driven 3-5% comp growth over the past 3 quarters
  - HomeGoods:** Beneficial exposure to housing recovery through HomeGoods & HomeSense franchises which has driven 6-9% comp growth over the past 3 quarters
  - Europe:** Sole off-price retailer in Europe, providing first mover advantage. There is substantial growth potential in current markets, and plans for expansion into new markets (opened 3 in Austria and 1 in Netherlands) – comp growth up 7%

## Analysis of Performance

The investment thesis stemmed from our belief that off-price retailers stood to gain from an increasingly cost-conscious, value-seeking population. This year, TJX rallied to an unprecedented high, fell during the last quarter amid wage increases and FX concerns and subsequently rallied by demonstrating strong sale growth. Over the course of the year, the tenets of our investment thesis were corroborated by TJX's (+4% over the year) outperformance of its full-price retail peers. Full price retailers such as Macy's (-47%) and Nordstrom's (-37%) are struggling to compete with their off-price peers. Nordstrom's off-price segment grew 12% over the year while its full-price model only grew 3%. The continued decline in full-price consumption represents an opportunity for TJX and its off-priced peers. We are very confident in TJX's long-term prospects and expect it to continue to outperform its full-price competitors

## Valuation Summary



# Performance Sports Group (TSX: PSG)

## Company Overview

- Performance Sports Group (formerly Bauer) designs, manufactures, and markets sports equipment and related apparel in the hockey, lacrosse and baseball/softball segments under the BAUER, MISSION, MAVERIK, CASCADE, INARIA, COMBAT, and EASTON brands
- Recent News: In September 2015 and on January 9<sup>th</sup>, 2016 former chairman W. Graeme Rouston has written letters to the company criticizing current practices and threatened to launch a tender offer

## Catalysts

- Significant Baseball growth with 30% market share in fragmented market with ~12 competitors
- Long Term: Proven target acquisition strategy; Leverage PSG platform to establish and integrate target companies
- Possible takeover bid from former chairman W. Graeme Rouston

## Risks

- Depressed Canadian dollar can continue to harm revenues
- Inability to clear current inventory at existing prices could diminish near term sales and hinder ability to pay off debt
- Rising participation costs and flattening participation rates in hockey

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

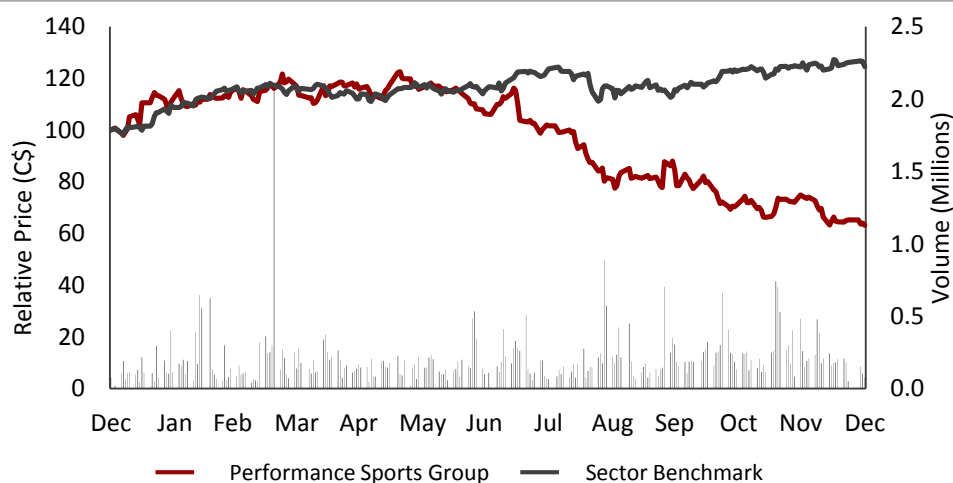
Share Price	\$13.34
S/O (mm)	45.6
<b>Market Cap.</b>	<b>\$607.7</b>
+ Total Debt	\$478
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$7
<b>Enterprise Value</b>	<b>\$1,079.0</b>
Beta (1-Year)	0.66
Dividend Yield	--
52-Week High	\$25.91
52-Week Low	\$13.34

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$613	\$626	\$671
% Growth		2%	7%
EBITDA	\$57	\$79	\$94
% Margin		13%	14%
EPS	-\$0.04	\$0.65	\$0.80
% Growth		-1688%	23%
EV/EBITDA	18.9x	13.7x	11.5x
P/E	-323.6x	20.4x	16.6x

## Market Performance



Benchmark: 100% RXI US Equity.

## Position Snapshot

Average Cost	\$12.96
# of Shares	3,485
Value Invested	\$46,490
Portfolio Weight	1.63%
2015 HPR	-36.9%
HP Benchmark Return	24.5%
Excess Return	(61.4%)

All figures in CAD

# Performance Sports Group (TSX: PSG)

## Investment Thesis

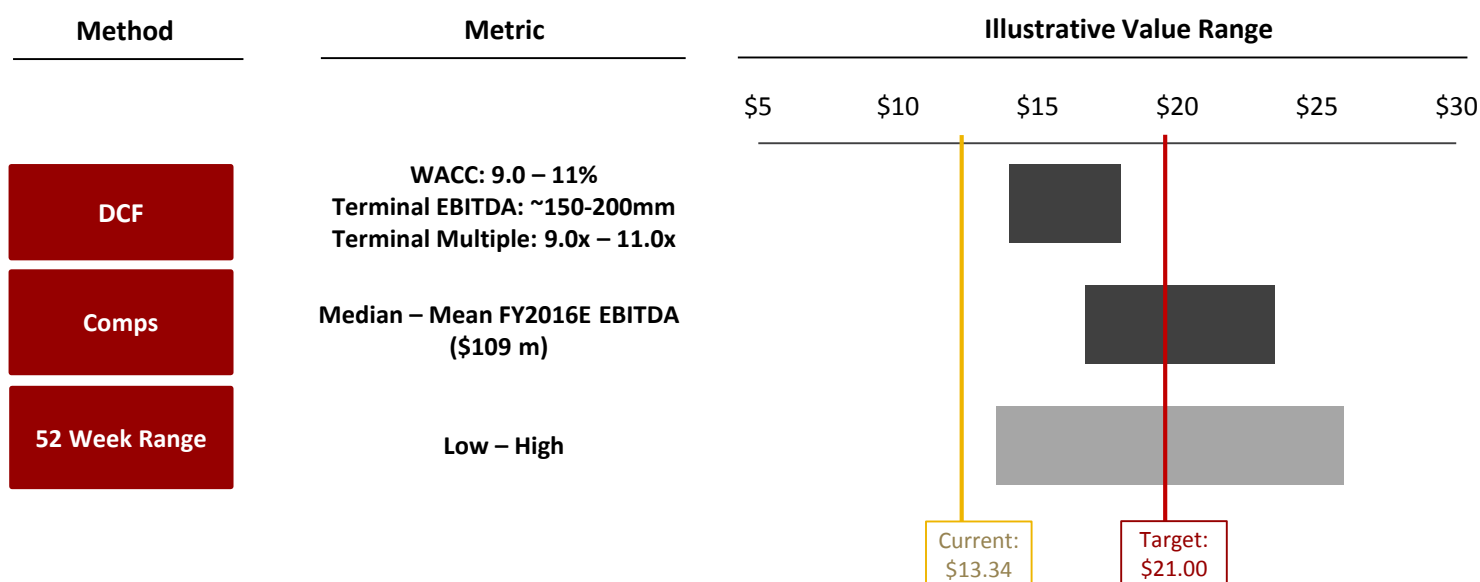
- Multiple Rerate & Valuation:** *We believed that the company would gain from a multiple rerate as it transformed into a multi-sport platform. Prior to the recent selloff, this was realized and PSG was trading in-line with its peer set.*
  - The company now again trades at a discount to its peers
- Renewed & Diversified Growth:** *The company's intrinsic value is heightened by virtue of hockey & diamond sports' high single-digit CAGRs*
- Leverage Discount:** *We believed that the market was discounting the value of the EASTON acquisition given the company's high leverage. Company did trade at premium prior to selloff*
  - PSG debt levels are significantly above their peers and despite a 21% reduction in debt over the year, PSG expects its leverage ratio to continue to climb in the short term
  - Due the climbing leverage ratio, a 50 basis point increase in interest rate has been triggered (the term loan is now LIBOR plus 3.5%)

## Analysis of Performance

Over the past year, Performance Sports Group has dropped almost 50%. We have seen a multiple contraction as the company now trades at a discount to other multi-sport platforms such as NIKE at 9.9x EV/EBITDA. We believe that PSG's depressed price is unwarranted and we do see significant upside from here. In the 2014 Annual Report, the consumers team recommended exiting the position since it had surpassed its \$21 price target; however, we elected to hold the position. Once the impact of FX on revenues was announced the stock began to slide, eroding all of last year's gains. With talks of privatization and/or revisions to the current business plan we decided to hold onto the position.

We believe PSG's underperformance can be attributed to negative foreign exchange movements, challenging market conditions for hockey business in Russia and Eastern Europe, and retail consolidation of key US accounts. Management estimates that the continued weakening of the Canadian dollar lowered adjusted Q2 2016 EPS by 50% compared to the second quarter of 2015. The market is also likely pricing in PSG's FX exposure to its relatively high US dollar denominated debt. Research suggests that a 10% move in the CAD exchange rate could move EPS by about \$0.24. The economic contraction in Russia and Eastern Europe coupled with retail consolidation in the US has lowered bookings and repeat orders particularly within the hockey segment. That being said, we believe these factors to be short-term given the cyclicity and seasonality of the industry. The neck-worn device to prevent concussions that PSG is developing could be a game changer in the sports industry. Roustan's recent privatization bid could lead to a bidding war and significant upside so we remain confident in this position.

## Valuation Summary





# Ten Peaks Coffee Company Inc (TSX:TPK)

## Company Overview

- TPK decaffeinate and sells green coffee to coffee retailers and roasters
- Uses the Swiss Water Process, the only 100% chemical-free water process for third-party decaffeination and the world's only consumer branded process
- Located in Burnaby, British Columbia
- The company was formally an income trust which was restructured into a common public corporation in 2011

## Catalysts

- Positive volume growth and improvement in earnings and margins
- Increased sell-side coverage
- Development of technology that can capture and commercialize the caffeine extracted as a by product of normal operations, which will act as a supplementary revenue stream

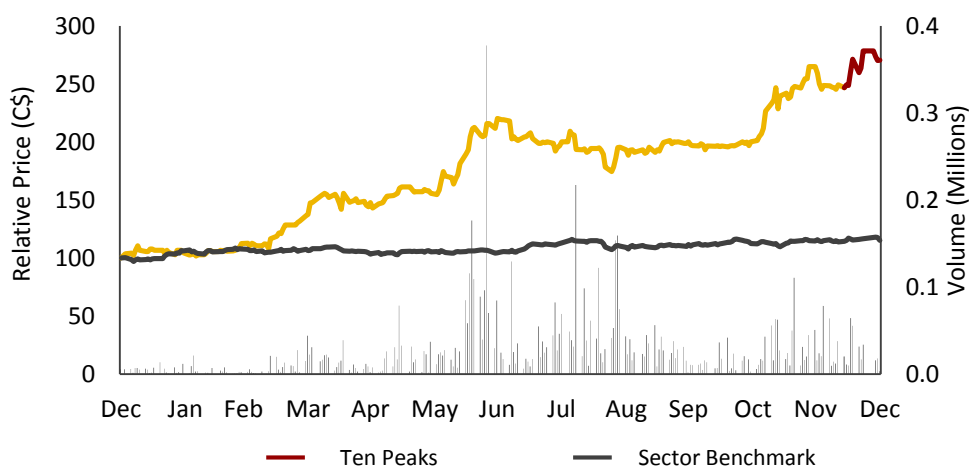
## Risks

- Customer concentration
- Competition from other methods
- Coffee price volatility

## Financial Summary

Public Market Overview		Financials & Multiples			
(values in \$M, as of Dec. 31, 2015)		(values in \$M)			
		LTM	FY2016E	FY2017E	
Share Price	\$11.90	Revenue	\$82	\$91	\$105
S/O (mm)	9.0	% Growth		11%	16%
<b>Market Cap.</b>	<b>\$106.9</b>	EBITDA	\$6	\$11	\$12.6
+ Total Debt	\$0	% Margin		12%	12%
+ Minority Interest	\$0	EPS	\$0.42	\$0.72	\$0.79
+ Preferred Shares	\$0	% Growth		70%	10%
- Cash	\$9				
<b>Enterprise Value</b>	<b>\$97.7</b>	EV/EBITDA	16.8x	8.7x	7.8x
		P/E	28.3x	16.6x	15.1x
Beta (1-Year)	0.36				
Dividend Yield	2.6%				
52-Week High	\$12.25				
52-Week Low	\$4.40				

## Market Performance



## Position Snapshot

Average Cost	\$11.07
# of Shares	5,540
Value Invested	\$65,926
Portfolio Weight	2.31%
2015 HPR	9.6%
HP Benchmark Return	0.8%
Excess Return	8.8%

All figures in CAD

Benchmark: 100% RXI US Equity.

# Ten Peaks Coffee Company Inc (TSX:TPK)

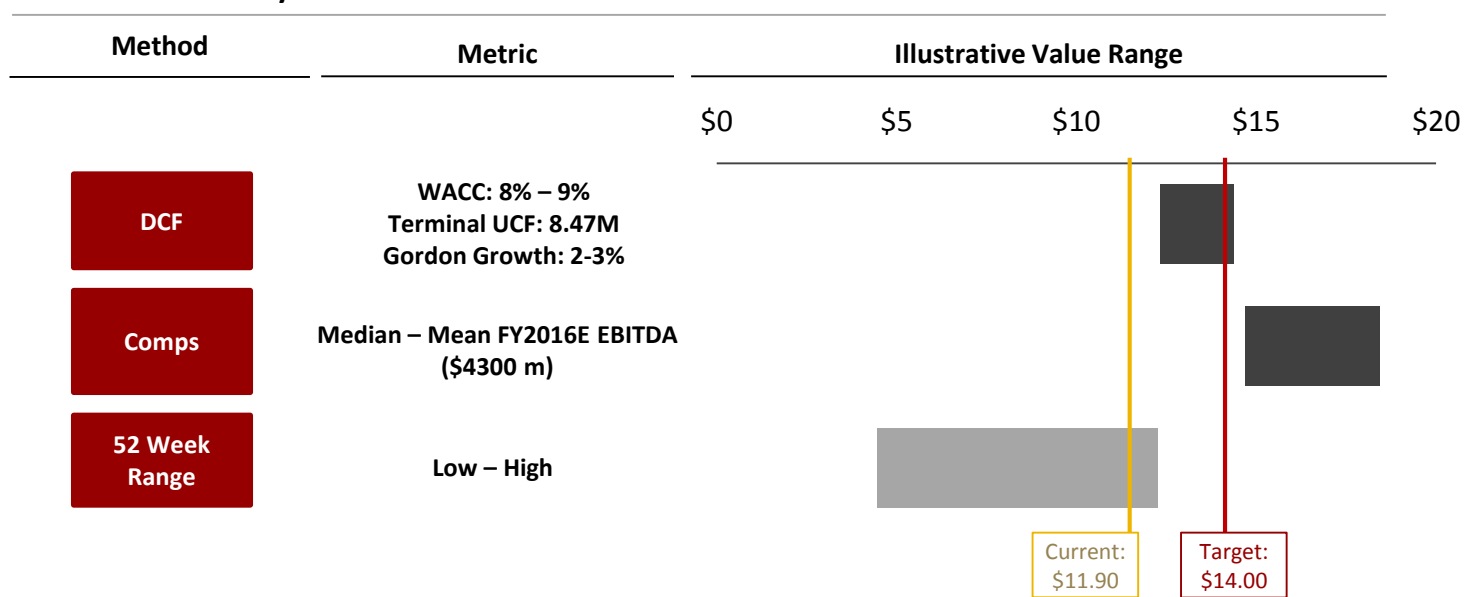
## Investment Thesis

- Premium position in decaffeination with strong growth runway**
  - Patented Swiss Water Process is the only 100% chemical-free, consumer branded decaffeination process
  - Processing volumes up 39% over past five years; improving gross margins and strong ROIC
  - Expansion plans in place for plant capacity, given growing US and international volumes
- Trend towards artisanal, high quality and fair trade coffee (Third Wave) to increase demand and expand total addressable market (TAM)**
  - Specialty coffee growth is promoting a shift from lower-quality chemical decaffeination methods to premium methods
  - TPK currently has approximately 70% market share in Canadian decaf; US market is ~10x the size, providing a large, growing TAM
- Valuation is attractive given growth prospects and monopolistic features**
  - Unwarranted discount to high-growth consumer plays based on current and forward EV/EBITDA
  - DCF base case yields ~25% upside
  - Unrivalled experience, strong trademark and reputation, organic accreditation and best-in-class methodology give TPK a virtual monopoly in the industry

## Analysis of Performance

While Ten Peaks was a recent addition to the portfolio it has already generated a 4.5% return in its first 15 day holding period. We are very confident in this position and expect to see significant upside in the coming quarters as processing volumes increase and TPK ramps up its US expansion. TPK's performance in 2015 was stellar with the stock returning 150% and making us wish we moved quicker to purchase shares. TPK's growth has been driven by incredibly strong volume growth coupled with margin expansion. Increased investor awareness of the story has led to increasing volumes which have helped drive the share price up further. Despite the incredible appreciation in share price, the stock remains attractive trading at 8.3x EV/EBITDA. Recent marketing endeavours, such as a pop-up store in New York, signals a potential ramp up in sales and we are excited to see what 2016 has in store for this industry-disrupting and rapidly growing company.

## Valuation Summary



# Industrials Sector

2015 Review & 2016 Outlook

*By Jordan Owen and Andre Cote-Barch*



# 2015 Sector Performance

## Industrials Benchmark Performance

The DCM Industrials sector underperformed the benchmark in 2015 by 13.2%. The graph in figure 1 takes into account USD currency appreciation. The iShares Industrials ETF experienced a decline of 3.6% due to the strong U.S. dollar, weak global growth and exposure to dwindling energy capital spending.

### DCM Performance

The Industrials sector returned 1.8% in 2015, compared to 15.0% for the sector benchmark.

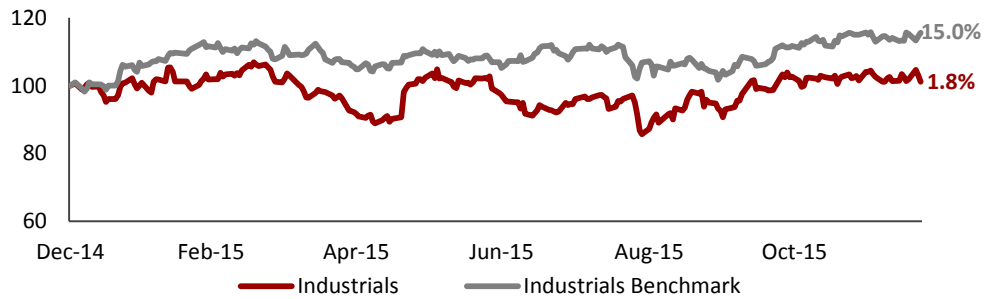
The underperformance was driven by our investments in Pangaea Logistics and to a lesser extent GM.

Pangaea Logistics fell from a high of \$4.01 last January, to a low of \$2.57 amid the headwinds faced in its industry. The sector has not been profitable for years due an oversupplied market, causing freight rates to fall. The Baltic Dry Index, shown in Figure 9, measures the price of moving raw materials by sea, and is currently at an all time low. Relative to a set of comparable companies, Pangaea outperformed its peers by 15% due to its competitive advantages in arctic shipping and its asset light strategy. (Figure 2)

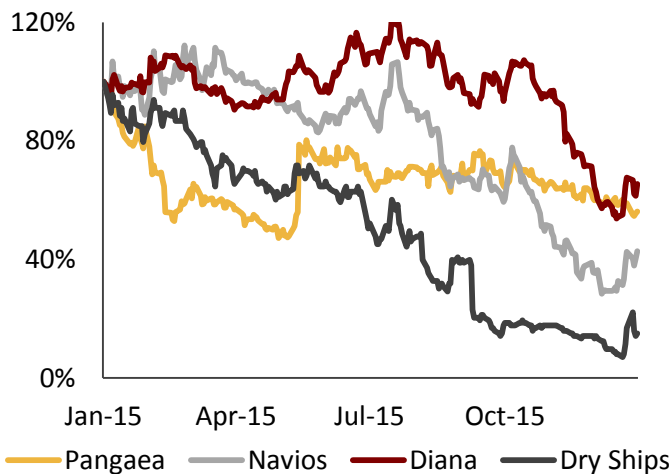
Our sector’s performance was also affected by our investment in General Motors, which moved from a price of \$34.3 in January 2015 to \$31.16 on January 13, 2016. It had global sales of 9.8 million vehicles in 2015, up 0.2%. GM’s 2015 U.S. vehicles sales were up 5.0% due to economic growth, low interest rates and cheap oil. However, the stock has declined due to concerns of a U.S. vehicle peak in 2016 along with rising interest rates. Moreover, the stock declined on fears of the Chinese economic slowdown and pricing pressure due to local competition. GM has the highest exposure to China versus its U.S. peers at 37% of global vehicle sales. In 2015, Chinese vehicle sales were up 5.2%. In Q4, GM beat consensus expectations of Chinese equity income by 8.4%. Relative to its global peers, GM had a slight underperformance of 0.5%. (Figure 3)

DCM invested in Union Pacific Railroad in December 2015. The rail industry has been depressed over the past year from the weakness in the energy freight demand. Moving forward, we see upside potential in freight volume growth driven by the auto, housing, intermodal and grain industries.

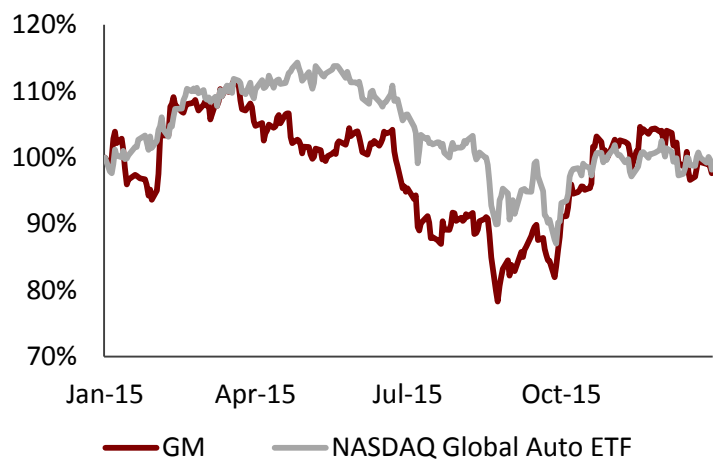
**Figure 1: DCM Industrials Performance**



**Figure 2: PANL Relative Performance**



**Figure 3: GM Relative Performance**



Benchmark: 100% iShares Dow Jones Industrials ETF.

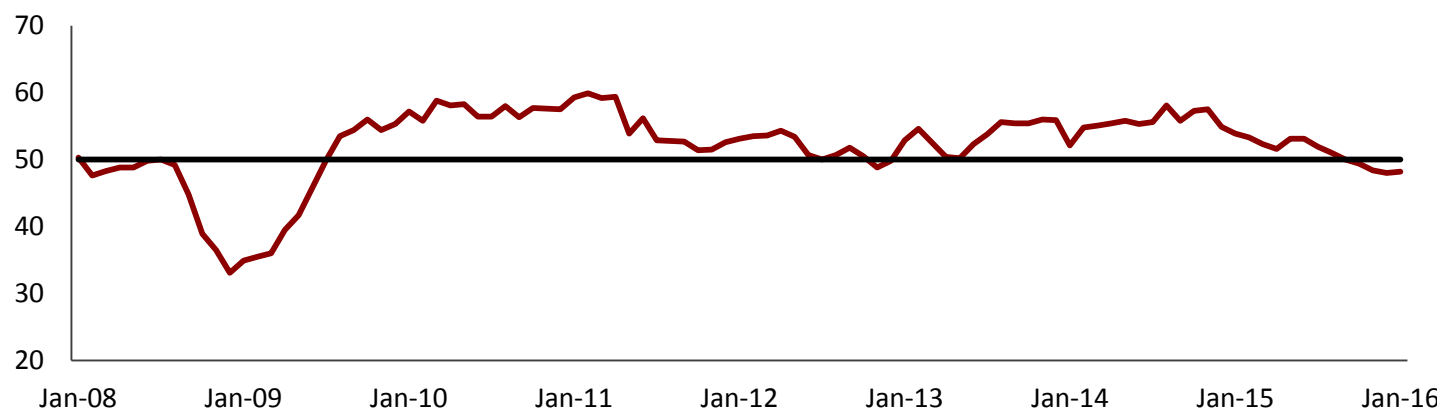
## Industrials Sector Overview

### Sector Overview

Industrials Sub-Sectors	1-Year Performance	Weight	Contribution
Industrial Conglomerates	14.2%	22.8%	3.2%
Machinery	-17.2%	19.1%	-3.3%
Commercial Services & Supplies	-5.6%	14.3%	-0.8%
Construction & Engineering	-19.5%	8.9%	-1.7%
Building Products	24.9%	6.4%	1.6%
Trading Companies & Distributors	-20.8%	6.2%	-1.3%
Airlines	-8.3%	5.4%	-0.5%
Electrical Equipment	-17.6%	5.2%	-0.9%
Air Freight & Logistics	-12.4%	4.1%	-0.5%
Road & Rail	-31.0%	3.3%	-1.0%
Aerospace & Defense	3.1%	2.2%	0.1%
Professional Services	4.5%	1.7%	0.1%
Marine	-31.8%	0.3%	-0.1%
<b>Industrials Sector</b>	<b>-3.6%</b>	<b>100.0%</b>	<b>-3.6%</b>

The Industrials Sector encompasses all of the sub-sectors provided in the table above. Global manufacturing has slowed down as the slowdown in China is weakening manufacturing in the United States. The Purchasing Managers Index (PMI) is an economic indicator of the health of the manufacturing sector. It is based on five major components which include new orders, inventory, production, supply deliveries and the employment environment. The graph in Figure 4 shows how the PMI index has evolved over time. A reading of above 50, depicted by the black line, represents an expanding manufacturing sector. The January PMI was registered at 48.2. Despite being below 50, this is an improvement from the December reading of 48.

**Figure 4: PMI Index**



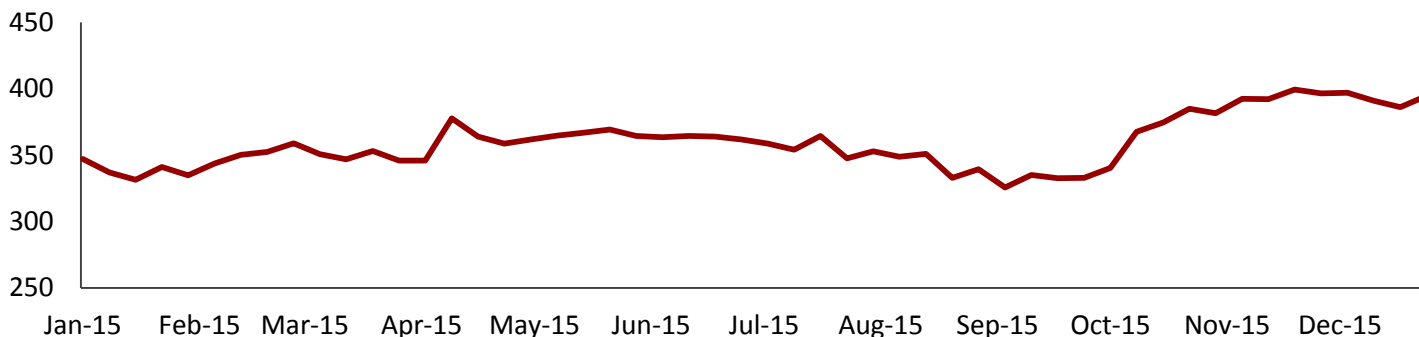
The European economy has improved slightly but we are skeptical that further upside can be more than modest. Despite the European Central Bank's accommodative monetary policy and the government shifting away from some inefficient policies, the effectiveness of the measures still appear limited. On the other hand, China has been aggressively responding to their slowing growth with a loosening monetary policy, which is expected to boost manufacturing.

Source: Fidelity Research

# Industrials Sector Overview

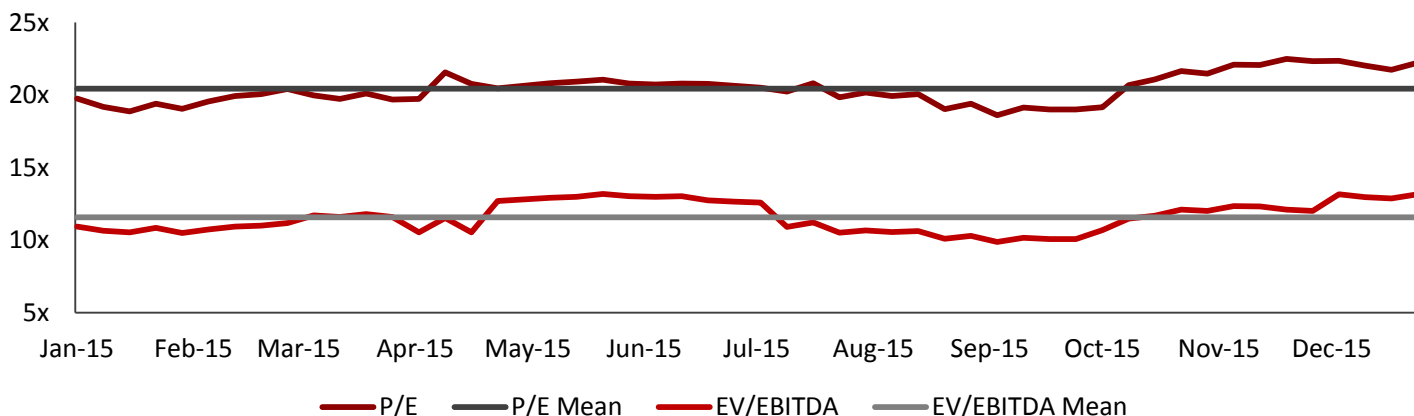
## Industrial Conglomerates – 2015 Overview

**Figure 5: S&P Industrial Conglomerates Price Index**



The graph above illustrates the price of the Industrial Conglomerates Index from January 2015 to January 2016. Overall, the index appreciated by approximately 14% amid a 12.4% and 20.3% increase in P/E and EV / EBITDA, respectively. The multiples shown in Figure 6 hit a high of 22.2x and 13.0x for P/E and EV/EBITDA in 2015, compared to a 5 year average of 17.9x and 9.3x, respectively. Valuations seem to be high today because the market seems to be pricing in potential M&A activity in the future. The market expects mergers and acquisitions to increase from 2015’s record year of approximately \$252 billion in M&A volume, shown in Figure 7.

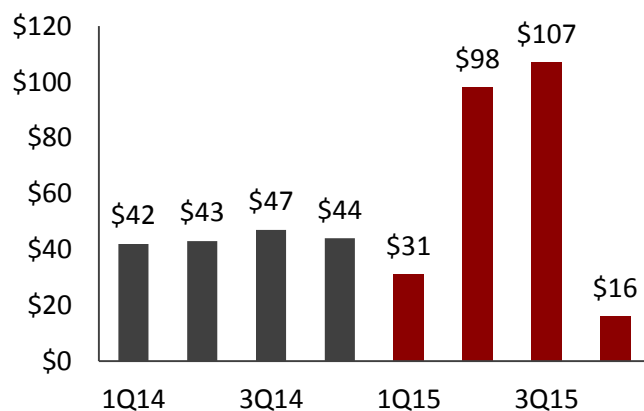
**Figure 6: Industrial Conglomerate P/E and EV/EBITDA Evolution**



## Industrial Conglomerates – 2016 Outlook

Industrial Conglomerates are expected to face a challenging year in 2016. The sector is facing a headwind with an expensive currency and lower raw-material prices. An important trend will be an increase in M&A activity from 2015’s record year, since many companies have the willingness and balance-sheet capacity to finance deals. The operational performance of multi-industrial companies in 2016 will also depend on end-market exposure. Commodity-related markets including energy and mining will remain weak, while aerospace, autos and construction markets are expected to post growth.

**Figure 7: M&A Deals (\$Billion)**



Source: Bloomberg Research

# Industrials Sector Overview

## Aerospace & Defense – 2015 Overview

The Aerospace and Defense industry returned 3.1% and outperformed the benchmark, which declined 3.6%. Revenues in the sector declined 0.5% in 2015.

In the Commercial Aerospace sub-sector, valuations remained steady at 14-15x 2015 earnings. The sector experienced rising profitability due to rising production rates. Aircraft orders were high on low interest rates and improved fuel-efficient aircrafts. Air traffic growth was up 6.7% in 2015, which is 1.5% above the long-term trend. Air traffic growth was supported as lower oil prices reduce airfares for passengers.

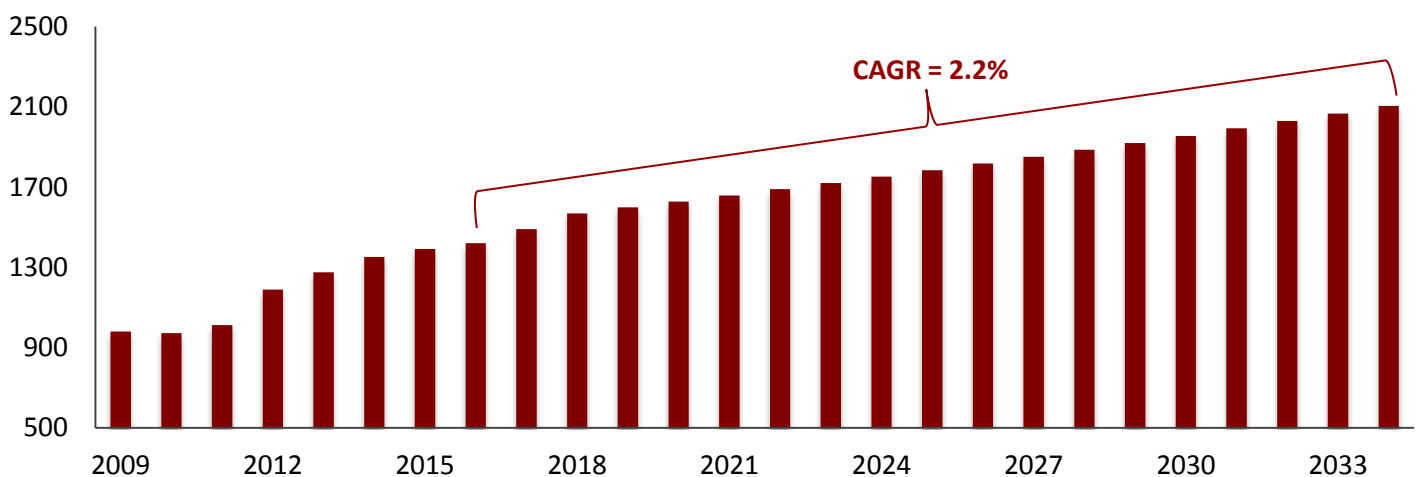
In the Defense sub-sector, valuations rose as P/E 2015 increased from 16x to 19x. Valuations rose on U.S. budget resolutions for 2016 & 2017 and on the expectation that defense spending would increase following the Paris attacks. In addition, multiples increased due to conflicts in the Middle East, Ukraine and the South China Sea. In 2015, the Defense Sector experienced declines in revenues on cuts to global military expenditures. The U.S., which accounts for 34% of global military expenditures, has cut spending in the recent years as the U.S. has ceased operations in Iraq and Afghanistan.

## Aerospace & Defense – 2016 Outlook

In Commercial Aerospace, a large order backlog will increase aircraft production, revenues and earnings. Companies are expected to make greater investments to increase future production rates. Aircraft orders will decrease on large backlogs and rising interest rates. The low fuel prices will decrease the benefit of ordering new fuel efficient aircrafts. The International Air Transport Association expects airline passenger traffic growth to be 6.9% in 2016. Passenger travel demand will see growth in emerging markets including India, China and the Middle East. However, there is a risk that aircraft orders will slow on concerns that air travel growth will decelerate in emerging markets. In the next 20 years, passenger and freight traffic is expected to grow at an average annual growth rate of 4.6% and 4.4%, respectively. As a result, aircraft deliveries will increase at a compound annual growth rate of 2.2%. (Figure 8)

It is expected the defense sector will return to revenue growth in 2016 due to rising defense budgets. Defense contractors will buyback shares to increase EPS as revenue and profits will see minimal growth on slightly higher budgets. In the U.S., the prospect of a Republican president would be a catalyst for defense spending in 2018 and beyond. In addition, it is expected that U.S. defense contractors will be pursuing growth in foreign markets in 2016. The governments of the UAE, Saudi Arabia, India, South Korea, Japan, India, China and Russia are expected to bolster their defense spending. The threats of terrorism, sovereignty security and cyber security will encourage spending.

**Figure 8: Aircraft Deliveries**



Source: Deloitte 2016 Global Aerospace and Defense Sector Outlook, Bloomberg

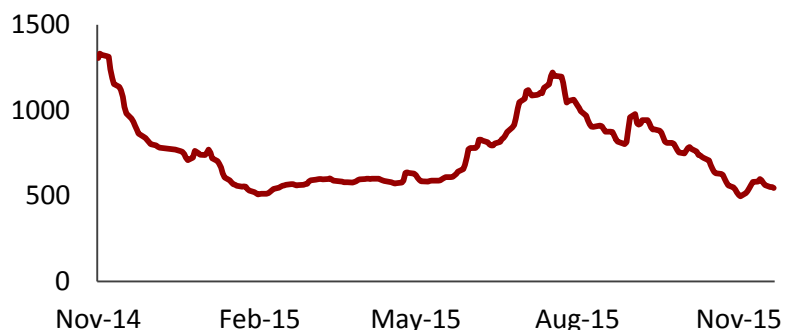
# Industrials Sector Overview

## Marine – 2015 Overview

The Baltic Dry Index, as shown in Figure 9 is an indicator that provides an assessment of the spot price of moving major raw materials by sea. The BDI measures the daily average earnings for Capesize, Supramax, Panamax and Handysize vessels.

After seeing a recovery during the summer to \$1,222, the index quickly fell to 354 on January 24<sup>th</sup> 2016. The industry remains bleak as asset values are at 15 year lows.

Figure 9: Baltic Dry Index

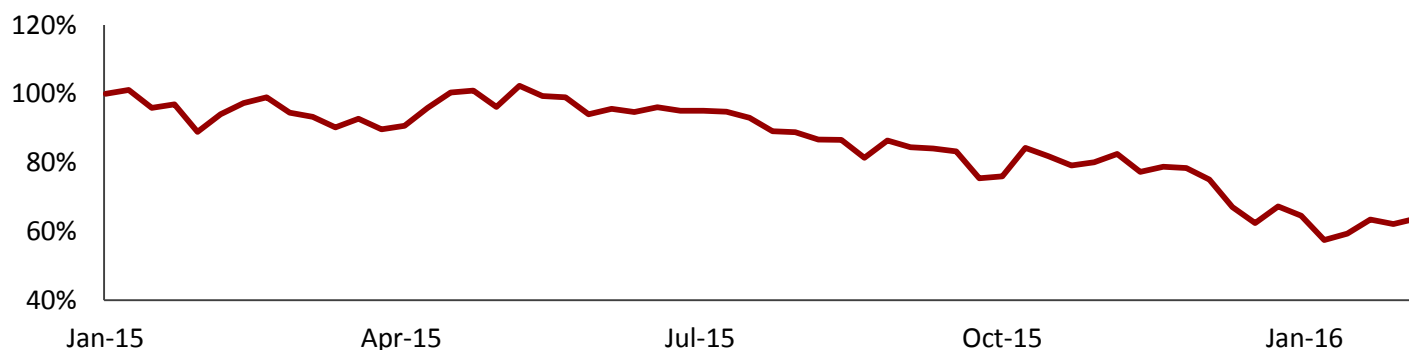


The question that remains is why are the rates so low. The main reason for a historical low in the BDI is due to the oversupply of vessels. In the lead up to the financial crisis, the world economy boomed and the BDI reached an all time high of \$11,800 in May 2008. The high in shipping rates spurred vessel orders. Over the short run, the supply of vessels is inelastic as it takes three years for ships to be delivered. The vessels became operational during the soft demand environment experienced after the crisis and caused the BDI to crash. In 2013, a surge in Chinese coal imports spurred further orders, as shippers expected coal imports would continue to rise. Along with shipping analysts, DCM expected a recovery of freight rates on moderate demand growth and low supply growth. In contrast, demand growth slowed down in 2015, mainly driven by China. China represents a majority of the world’s ship-borne iron ore and 25% of coal. Chinese coal were down 30% on slower economic growth and a decline in domestic prices. Overall, demand growth in the 2015 was 0%. On the supply side, fleet capacity grew by 2.6%, which represents a record twelve-year low. The low rates have increased demolitions, as older vessels are more expensive to operate and have lower fuel efficiency. Freight rates continued to decline as the imbalance between supply and demand growths worsened.

The marine freight sector depreciated by 36.2% in 2015 (Figure 10) compared to DCM’s holding Pangaea Logistics, which depreciated by 33.9%. Shipping firms are expected to generate a profit in 2016 by increasing efficiencies and cutting costs, compared to a loss in 2015. Still, 2016 is unlikely to be entirely smooth, given the challenges from excess supply and decelerating Chinese demand. Figure 11 on the next page illustrates the projected growth rates for supply and demand in 2016. Supply growth is expected to continue to outpace demand, which could weigh on rates.

Shippers’ ability to manage capacity and raise rates will be the key to profitability in 2016. Included in the forecasts is Iran’s re-entry into the tanker markets. The National Iranian Tanker Company owns the world’s largest fleet of Very Large Crude Carriers (VLCC). Now that the sanctions have been lifted, Iran can deploy their fleet, which will possibly pressure rates further.

Figure 10: Marine Index 2015 Performance



Source: Bloomberg Research & BIMCO



## Industrials Sector Overview

### Marine – 2015 Overview and 2016 Outlook

Figure 11: 2015 and 2016 Shipping Supply/Demand Forecasts

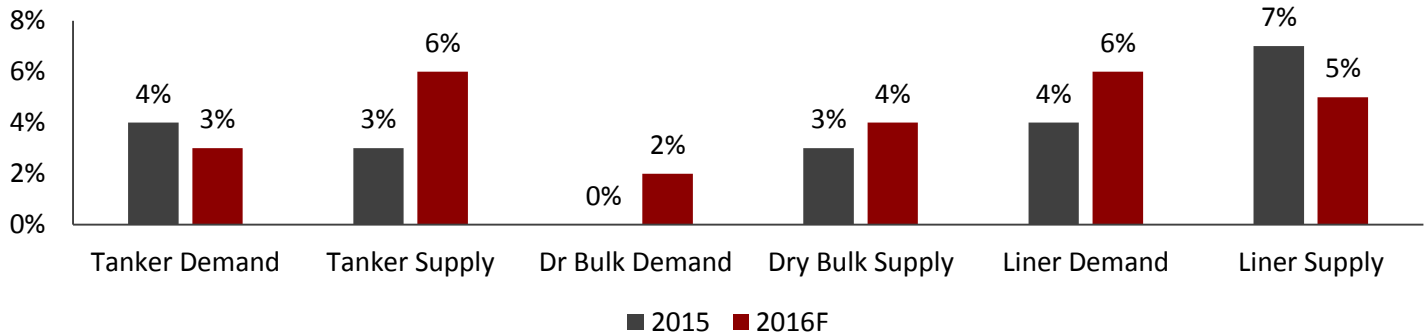
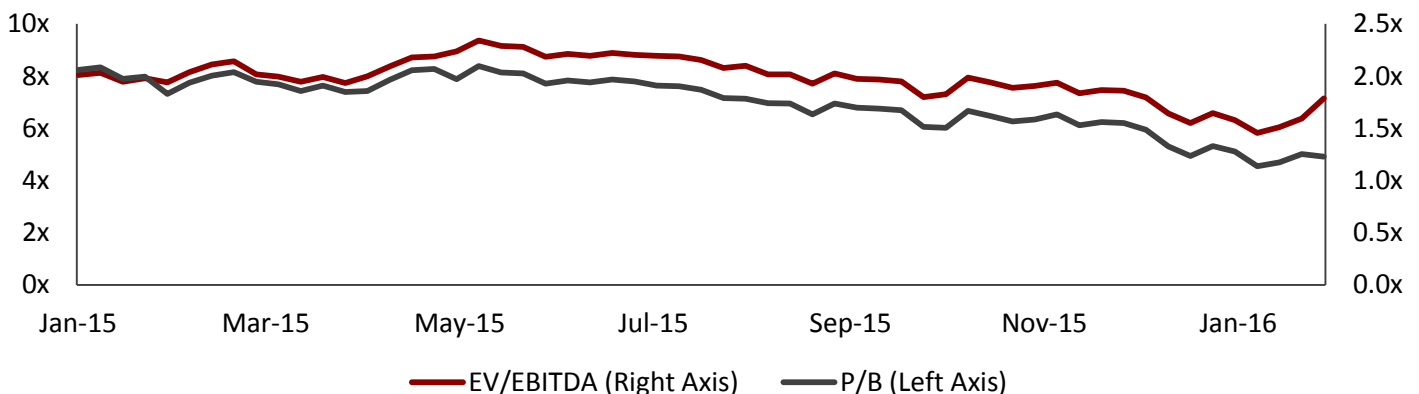


Figure 10 illustrates that the marine shipping sector has suffered in 2015 from excess capacity. Shipping price-to-book multiples have fallen from a high of 2.1x to a low of 1.1x, which represents a 45.8% decrease. The overall group is trading at a deep discount to the S&P 500 Index's 2.8x price-to-book ratio. According to an aggregate of industry estimates, dry bulk time charter rates are expected to increase by 26% in 2016 following the 23% decline in 2015. These expectations may be optimistic since dry bulk demand is expected to rise by 2% while net capacity or supply will increase by 4% according to Clarksons Research estimates. The increase of demand from other emerging markets outside of China may ease the slack capacity. Chinese demand for Iron Ore and Coal is expected to increase by 1-2% in 2016. This will serve as a tailwind for the industry as these commodities make up about 75% of dry-bulk tonnage, with China accounting for approximately 73% of the total freight demand of the aforementioned commodities.

Vessels	2015 Time Charter Estimates	2016 Time Charter Estimates	Expected Growth
Capesize	\$9,750	\$9,500	-3%
Panamax	\$6,750	\$7,500	11%
Supramax	\$7,615	\$8,000	5%
Handysize	\$6,250	\$7,000	12%
<b>Average</b>	<b>\$7,591</b>	<b>\$8,000</b>	<b>5%</b>

Dry-bulk time charter rates are expected to rise by 5% on average in 2016, according to 39 analysts surveyed. Depressed oil prices have and will continue to serve as a tailwind for freight demand and spot rates moving forward because binge buying of crude oil have increased as importers build up cheap reserves.

Figure 12: Marine Shipping EV/EBITDA and Price-to-Book 2015



Source: Bloomberg Research

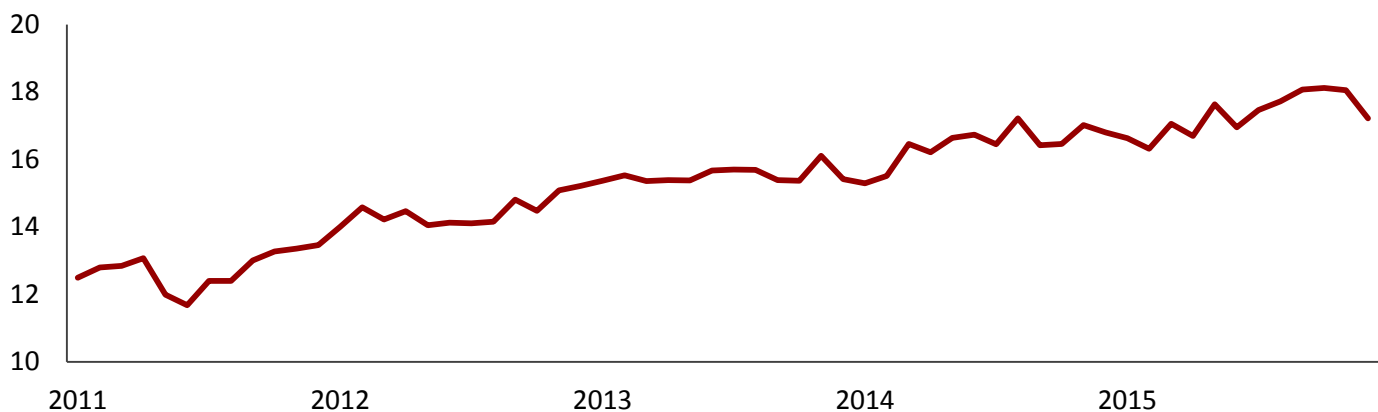
# Industrials Sector Overview

## Automotive Industry

Global automobile stocks declined 1.8% in 2015, an outperformance of the industrials benchmark.

Macro Drivers	Micro Driver
GDP: Impacting consumer confidence	Tax/Import Duties: Changes in these factors ultimately change the price of the vehicles
Income Distribution: Indicates total market potential as well as whether growth is more likely at the entry level, upper or mid-market	New Model Activity: Certain models impact the market product mix, ex: a new VW Gold is made every six years
Employment: Employment rates by age and gender hint at future popularity of small vs. large cars	Wildcard: Terrorism, natural disasters... will have a negative impact on demand
Oil Prices: Lower fuel price puts money back in the people's pockets and fuels new car sales, especially trucks	

**Figure 13: U.S. Annualized Light-Vehicle SAAR (M)**



In 2015, global auto sales increased 1.5%, the slowest growth since 2010. Dropping oil prices have been a historical tailwind to the industry growth. (Figure 14) Lowering oil prices increases customer willingness to buy more fuel intensive trucks and SUVs. (Figure 15) This is an important trend because truck and SUV sales generate the highest profit margins in the industry.

In 2015, U.S. light-vehicle SAAR was 17.5 million, up 5.7% YoY as it reached a 15-year high. European vehicle sales were up 3.3% in 2015. In developed nations, automobile sales were driven due to economic growth, low interest rates and cheap oil. China's vehicle sales growth slowed to 4.7% on weak economic growth. Firms exposed to the Chinese auto industry have been facing negative pricing forces, causing overall valuations to fall. Other emerging markets also struggled as Brazil and Russia experienced a decline of 25.5% and 35.7% respectively. Brazil declined as a result of economic contraction and rising inflation, unemployment and interest rates. The Russian vehicle market faced headwinds from a weak ruble and economic turmoil.

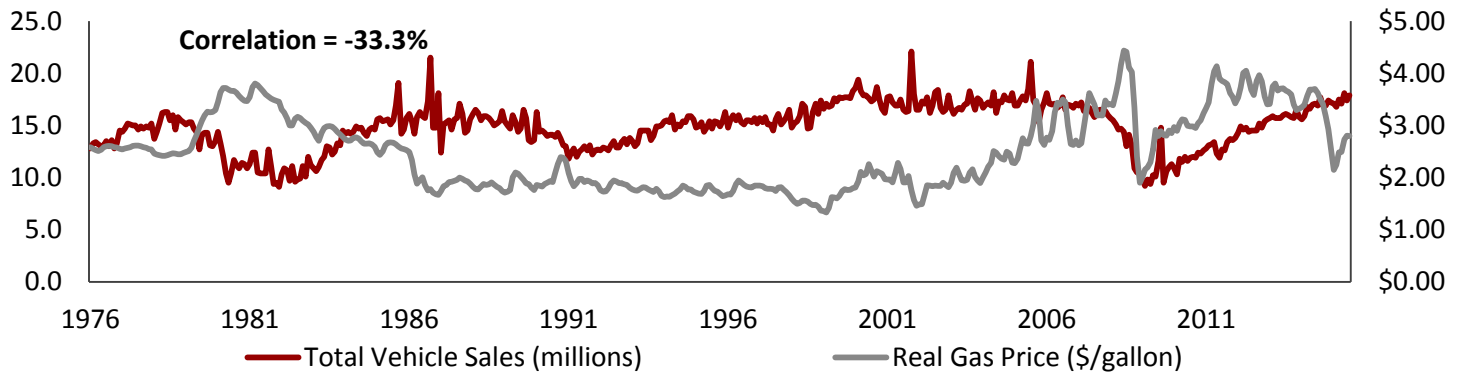
In 2015, the National Highway Traffic Safety Administration stated that 51 million vehicles were recalled, the second highest in history after 2014. Recalls occurred for reasons including cyber security, rupture prone air bags and ventilation systems. In September, the EPA discovered that Volkswagen had used software designed to beat emission tests. The pollutants emitted by these vehicles were up to 40 times more than the acceptable standard. The EPA ordered the recall of 482,000 diesel-powered vehicles and leveled a fine up to \$18 billion on Volkswagen. Since the scandal, Volkswagen's market share in the auto sector has declined 2.5% and the stock has dropped 23% up to the end of 2015. Automakers sell 90% of their diesel engines in the Europe. The Volkswagen emissions scandal tests the EU's patience with clean diesel, which could accelerate the tightening of anti-emission laws, putting pressure on demand for diesel vehicles.

Sources: Wall Street Journal, Bloomberg, Analyst Research

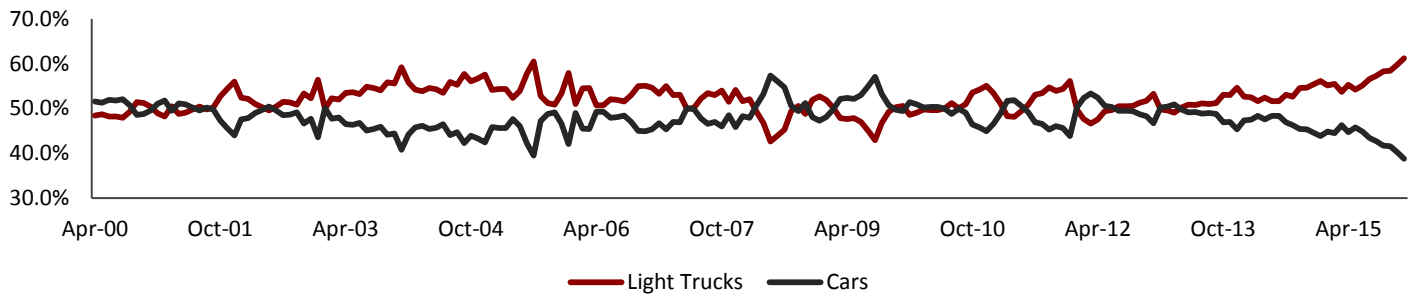
# Industrials Sector Overview

## Automotive Industry

**Figure 14: Low Oil Prices Drive Vehicle Sales**



**Figure 15: Trucks Outselling Cars**



**Figure 16: Pricing Pressures in China**

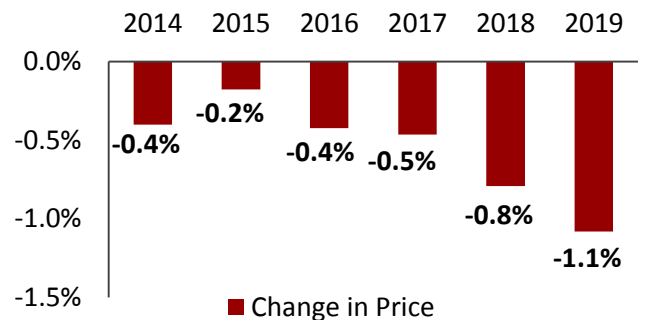


Figure 16 illustrates the short term pricing pressures in China. The graph shows that firms selling vehicles in China will experience an approximate negative 1% pricing pressure every year until 2019. On average, a firm that is exposed to the Chinese market will see a decrease in net income by 3% for every 1% drop in price. Vehicles prices may continue to fall 4-5% in 2016.

### Automotive Industry – 2016 Outlook

IHS Automotive is expecting a 2.7% increase in global sales. The continued low oil prices and low interest rates will continue to increase sales. It is expected that U.S. market will grow in 2016 and 2017 on economic growth and employment gains, reaching 18 million annual vehicle sales. The rising interest rates in the United States will be a slight headwind. Europe’s growth is expected to slow to 2.5-3% in 2016. The Chinese market is expected to grow 5-6% in 2016, aided by a tax cut for vehicles with engines of 1.6 liters or less. The Russian market will continue to contract and Brazil will have a further decline of 14%.

Electric vehicles are more likely to prevail in the near term as Asian automakers strive to achieve the new tighter fuel-economy and emissions standards. These standards aim to improve fuel economy by 31% by 2020. This is encouraging automakers to further research and develop hybrid and electric vehicles. Hydrogen fuel-cell vehicles like Toyota’s Mirai are still developing, even as battery and hybrid-powered models have gone mainstream. China will continue to push battery power as it builds out its vehicle-charging-station infrastructure.

Source: Bloomberg Research

# Industrials Sector

Holdings Review



# Union Pacific Corp. (NYSE:UNP)

## Company Overview

- Union Pacific Corp. (UNP) was incorporated on July 1, 1969
- UNP is one of America's leading transportation companies
- Its principal operating company is North America's premier railroad franchise, covering 23 states across the western two-thirds of the U.S.
- Its track has 31,974 route miles and maintains coordinated schedules with other rail carriers to move freight
- Its business mix includes agricultural products, automotive, chemicals, coal, industrial products and intermodal

## Catalysts

- The recovery of the coal market is projected to be quicker than investors are expecting, allowing freight volumes to rise
- Trains are still the most efficient mode of transportation and the industry is projecting an increase in operating efficiencies moving forward

## Risks

- Uncertainty over the freight projections may have a material effect on a top-line growth
- The strong USD may cause lower foreign demand for U.S. products, leading to lower freight volume
- Lower oil prices may cause a switch in the industry towards the trucking freight

## Financial Summary

### Public Market Overview

(values in \$mm, as of January 16th, 2015. except for Share Price)

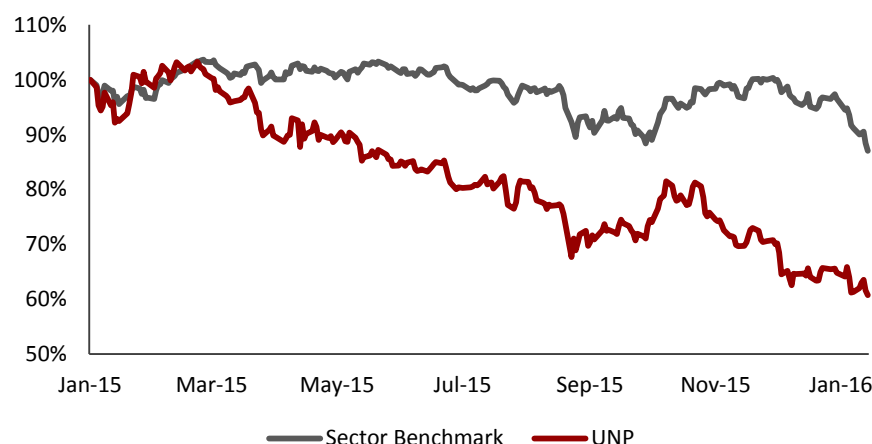
Share Price	\$74.12
Shares Outstanding (mm)	854.1
Market Cap.	\$64,418
+ Total Debt	\$13,339
+ Minority Interest	\$0
+ Preferred Equity	\$0
- Cash	\$2,041
Enterprise Value	\$75,716
Beta	0.99
Dividend Yield	4.0%
ROIC	30.4%
52-Week High	\$123.83
52-Week Low	\$72.67

### Financials & Multiples

(values in \$mm)

	LTM	FY2016E
Revenue	\$22,758	\$22,153
% Growth	-3.0%	-2.7%
EPS	\$5.79	\$5.86
% Growth	6.9%	1.2%
P/E	13.0x	12.9x
P/BV	3.1x	3.0x
P/Sales	2.8x	2.9x

## Normalized Stock Price and Sector Benchmark Performance



## Position Snapshot

Average Cost	\$105.69
# of Shares	635
Value Invested	\$68,979
Portfolio Weight	2.42%
2015 HPR	9.0%
HP Benchmark Return	6.1%
Excess Return	2.9%

# Union Pacific Corp. (NYSE:UNP)

## Investment Thesis

### 1. Rail Industry Currently Trades at a Discount Due to Volume Decline in 2015

- **Upside:** As long term freight volumes increase, UNP will experience multiple expansion

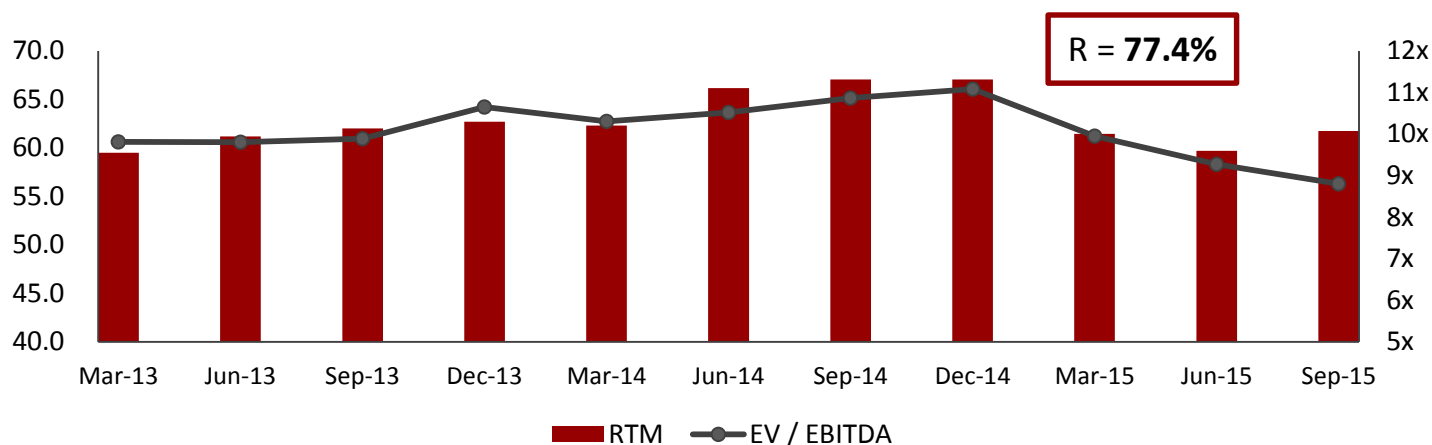
### 2. Best Operator in the Industry

- **Upside:** Best service offering along with a falling operating ratio will generate superior profitability over its competitors

### 3. Valuation Yields Upside at Current Price

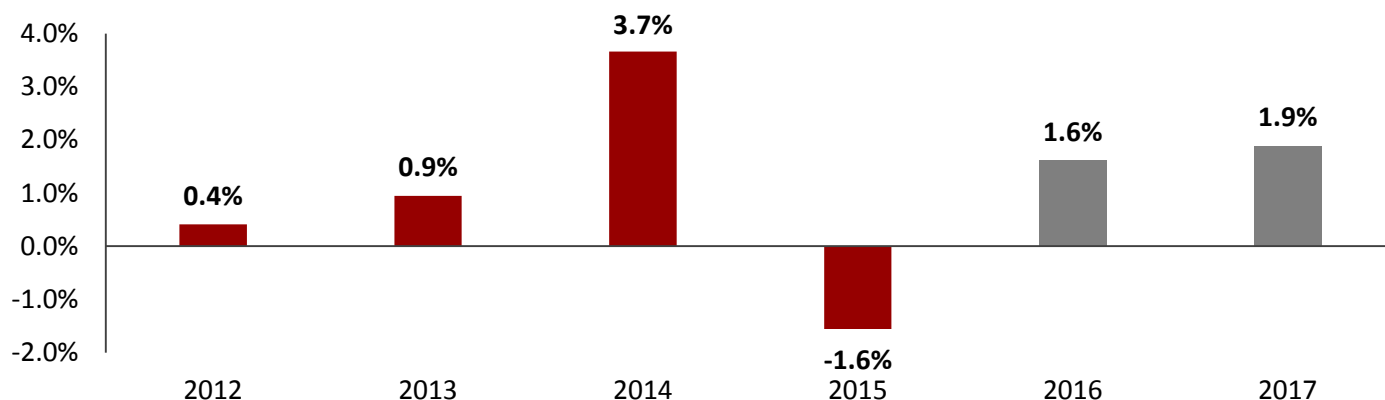
- **Upside:** 33.7% base case upside, given conservative estimates, with a price target of \$100.5

## Thesis #1: Industry Average Revenue Ton Miles (mm) vs. EV / EBITDA Multiple



The graph above illustrates that there is a 77.4% correlation to RTM's and EV / EBITDA. The main reason is because investors see freight volume as the firms capability to generate cash flows in the future. Moving forward, the industry is expected to experience a rise in terms of freight volume, which should result in an increase in the EV / EBITDA multiple.

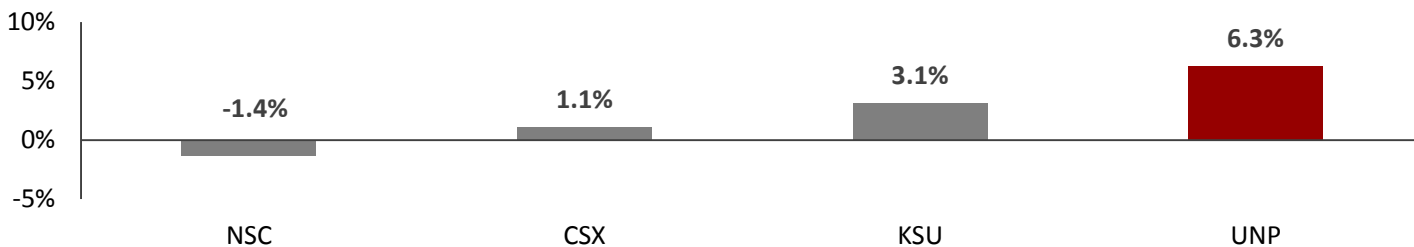
## Thesis #1: Overall Freight Volume Projection



The graph above illustrates an aggregate of the industry projections for Union Pacific's business mix volume growth. It is a weighted average, incorporating the percent allocation to each business class. It shows that Union Pacific is projected to see positive growth in terms of freight volume in the future.

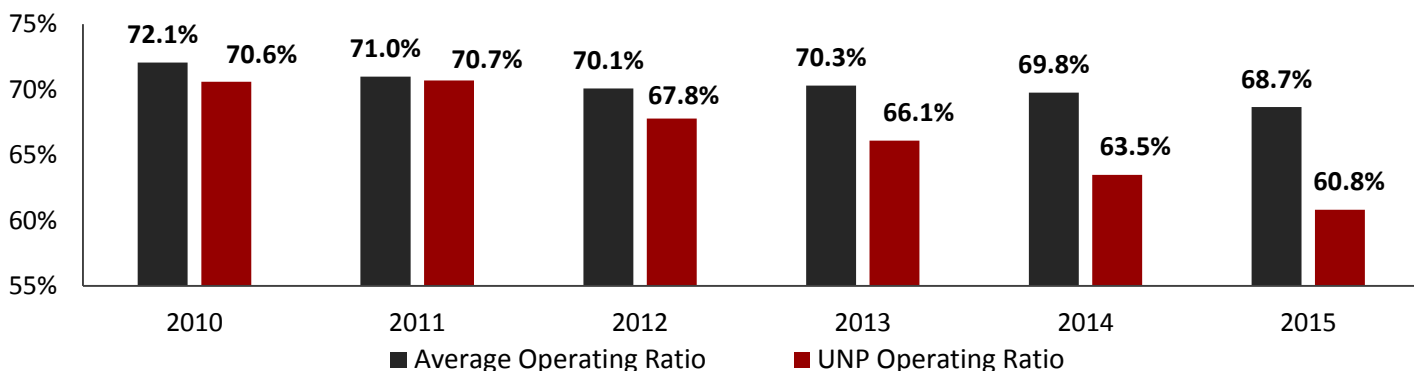
# Union Pacific Corp. (NYSE:UNP)

## Thesis #2: 4-Year Compounded Revenue / RTM Growth



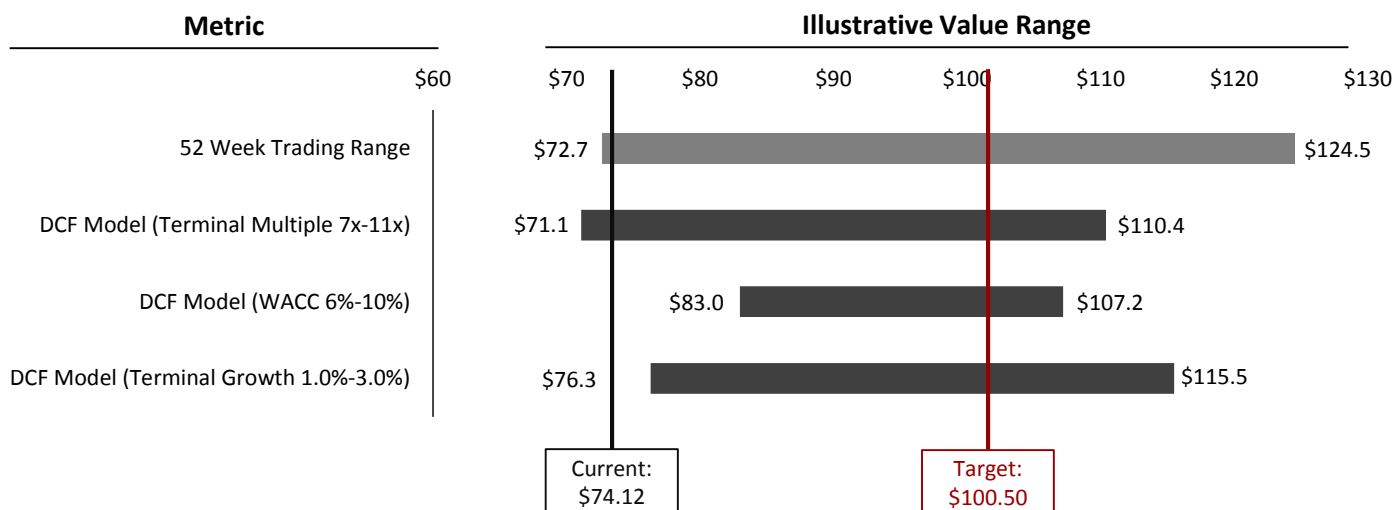
Union Pacific Corp. displays higher potential in terms of Revenue / RTM over a four year compounded growth. This metric illustrates the firm’s capability of increasing prices. In other words, it can be interpreted as the growth in the rate the firm charges its clients. The Company is capable of increasing prices at a faster rate than its competitors because of the lack of competition in the West Coast.

## Thesis #2: Long Term Decline in the Operating Ratio



The operating ratio is calculated by taking one minus the operating margin. It is the main metric used in the industry to calculate a company’s cost efficiency. Union Pacific has been successful in reducing the operating ratio at a much greater pace than industry average. This year, the industry has been struggling in terms of top-line growth. UNP reduced the operating margin further by reducing employee headcount and other cost minimizing strategies. Moving forward, UNP expects to continue to reduce their operating ratio, targeting the high 50’s by 2019.

## Valuation Summary



# Pangaea Logistic Solutions (Nasdaq: PANL)

## Company Overview

- Founded in 1996 and headquartered in Rhode Island, PANL is a company that provides seaborne transportation services for dry bulk commodities worldwide
- It transports commodities such as iron ore, bauxite, coal, limestone, clinker, grains and pig iron
- Operates a fleet of approximately 60 vessels: 14 vessels which it owns and 31-46 vessels it charters-in
- The company began trading on the NASDAQ on October 3rd 2014 after being acquired by Quartet Merger Corp, a public search fund

## Catalysts

- Future earnings provide an opportunity for the company to prove the important upside offered by Arctic Shipping
- Consistent growth in seaborne trade will support a rate increase at a CAGR of 5.0% of up to 2019
- Slower tonnage growth as low vessel utilization rates, 46% in 2015, reduces the order books of shipbuilders and spurs scrapping

## Risks

- Prolonged weakness in the Baltic Dry Index
- Continued slowdown in economic growth and imports into China, which accounts for 40% of dry bulk demand
- Reduction in slow steaming due to low fuel prices, increasing freight capacity

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

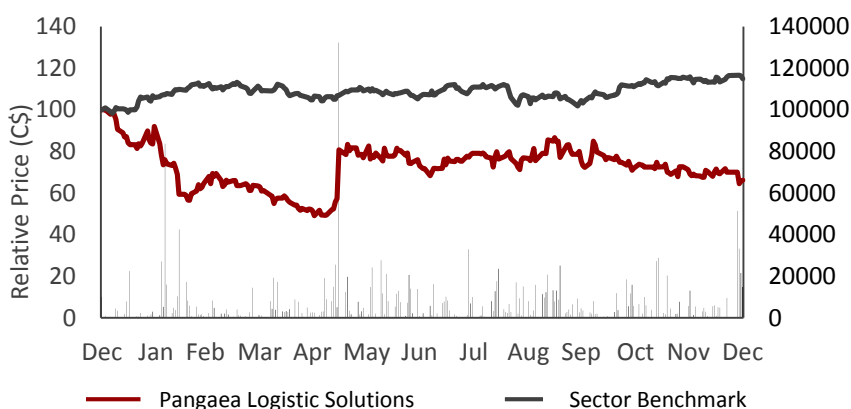
Share Price	\$2.64
S/O (mm)	35.9
<b>Market Cap.</b>	<b>\$94.9</b>
+ Total Debt	\$196
+ Minority Interest	\$5
+ Preferred Shares	\$0
- Cash	\$34
<b>Enterprise Value</b>	<b>\$262.2</b>
Beta (1-Year)	0.77
Dividend Yield	--
52-Week High	\$4.75
52-Week Low	\$2.22

### Financials & Multiples

(values in \$M)

	LTM
Revenue	\$334
% Growth	
EBITDA	\$31
% Margin	
EPS	\$0.25
% Growth	
EV/EBITDA	8.4x
P/E	10.4x

## Normalized Stock Price and Sector Benchmark Performance



Benchmark: 100% iShares Dow Jones Industrials ETF.

## Position Snapshot

Average Cost	\$6.13
# of Shares	10,749
Value Invested	\$39,718
Portfolio Weight	1.39%
2015 HPR	-33.8%
HP Benchmark Return	15.0%
Excess Return	(48.8%)

All figures in USD



# Pangaea Logistic Solutions (Nasdaq: PANL)

## Investment Thesis

- 1. Industry Leader in Artic Shipping:** *The company is a leader in the niche market of Artic shipping, owning a large portion of the world's 1-A Ice-Class tonnage*
  - This niche market is very profitable due to limited supply. PANL generates premium pricing of 57% over spot prices and voyage costs are on average 20-45% lower than traditional routes
  - A promising opportunity is the North Sea Route, as cargo in major Baltic ports is planned to grow at a CAGR of 22% over the next 15 years and days navigable per year continue to increase steadily as ice levels in the Artic have been consistently declining
- 2. Focus on Backhaul to Drive Profitability:** *By focusing on obtaining long-term Contracts Of Affreightments (COAs) on the less-traveled "backhaul" route (return trip), it can grow revenues and voyage days with less capex than its peers*
  - By transporting goods in these less commoditized routes, Pangaea builds a loyal-customer base by becoming embedded in its client's supply chain while providing value added logistics services
  - Time Charter Equivalent of \$11,849 per day, charging a premium on worldwide spot prices, currently around \$7,700 per day on a Panamax vessel
  - Asset-light strategy consists of chartering-in additional vessels to meet excess demand, if needed, and not having to make payments on unutilized ships in market downturns
- 3. Consistent, Acyclical Growth at an Attractive Valuation:** *To reduce its exposure to the weak spot market, PANL's strategy has been to charter-in vessels only to meet the demand of fixed rate and higher margin COAs.*
  - Diminishes the risk that additional capacity leads to losses in a volatile spot market
  - 21% CAGR in adjusted EBITDA from 2011-2014 in an environment of flat revenue
  - No cargo accounts for more than 16% of its traffic, reducing the risk of specific commodities

## Analysis of Performance

Since initiating our position in Nov 2014 at \$6.13, PANL closed out 2015 at \$2.64. The dry bulk index, a measure of spot freight rates, declined 38% during the year and reached a historical low of 471 points in December. Despite a twelve-year low in fleet capacity growth of 2.6%, there was no growth in maritime demand, resulting in a further decline in spot rates.

In alignment with its strategy, PANL's revenues have declined 21.6% YTD on reduced spot charter shipping days and lower freight rates. PANL's net income improved 228.6% YTD on higher operating margins, lower bunker fuel and reduced charter-in expenses.

We assign a hold rating to the stock. PANL continues to focus on the competitive advantages that allow it to outperform its industry. PANL is well positioned to deliver stronger earnings during higher rate environments.

## Valuation Summary

Method	Metric	Illustrative Value Range
Comps	EV / EBITDA - 7x-10x	Current: \$2.41   Target: \$3.65 \$1.4 - \$4.1
	DCF Bear - Term. Growth 1%-3%	\$2.3 - \$3.2
DCF	DCF Bear - WACC 9%-11%	\$1.7 - \$3.7
	DCF Base - Term. Growth 1%-3%	\$3.1 - \$4.4
	DCF Base - WACC 9%-11%	\$2.3 - \$4.6
	52-Week Range	\$2.1 - \$4.0

# Materials Sector

2015 Review & 2016 Outlook

*By Alexandre Veronneau and Sercan Demirtas*



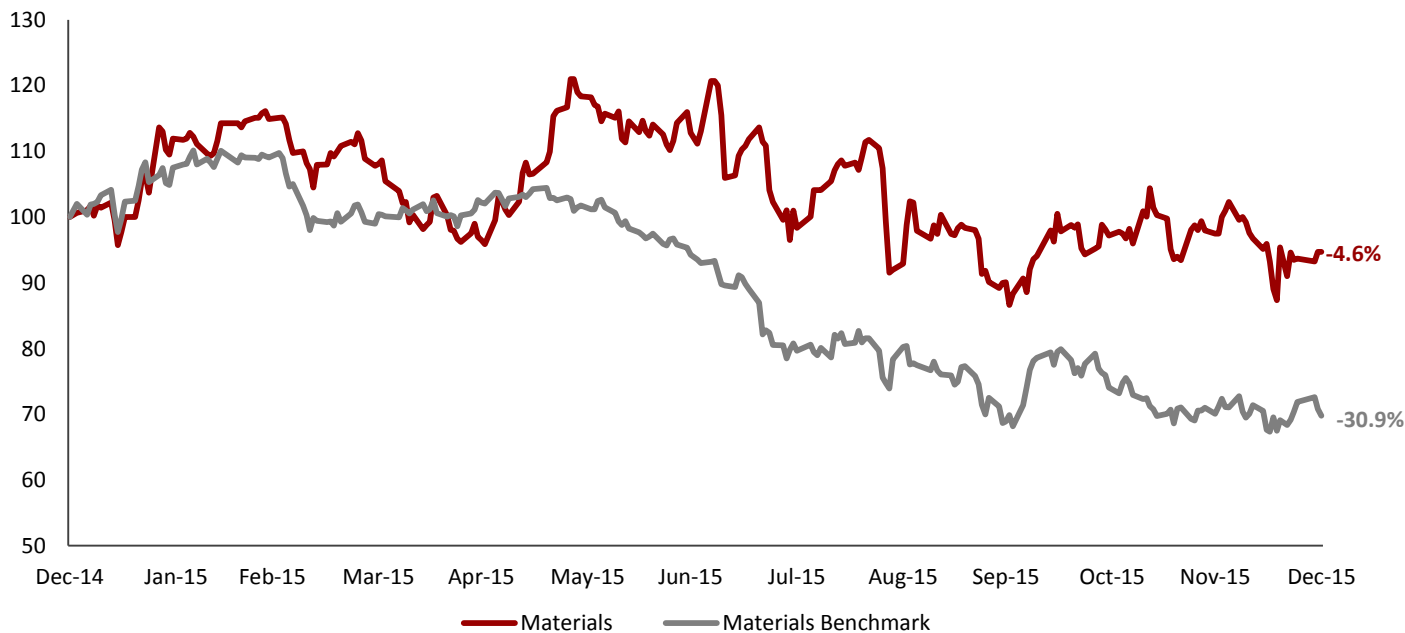
## 2015 Sector Performance

### DCM Performance

The Global Equity Fund's Materials sector returned -4.6% in 2015, a 26.3% outperformance vs. our sector benchmark. The outperformance was largely due to our decision to focus on companies whose operational flexibility minimized exposure to commodity price fluctuations. For example, our main holding, Western Forest Products (WEF), a Canadian forest products company, was able to offset unfavourable commodity lumber price fluctuations by shifting production towards value added specialty lumber products which proved to be more stable in terms of demand and pricing. Going forward, we will continue to focus on companies that have similar platforms until we have a strong conviction in short to medium term precious and/or base metals prices.

Although Lundin Mining (LUN) was largely responsible for our 14.9% sector outperformance in 2014, our lack of conviction on copper prices for H2 2015 led us to close the position in May once our price target had been achieved. The \$6.32 exit price marked a near 52-week high for the stock, and the shares have since nearly halved in price due to a sharp decline in copper prices.

**Figure 1: DCM Materials Sector Performance**

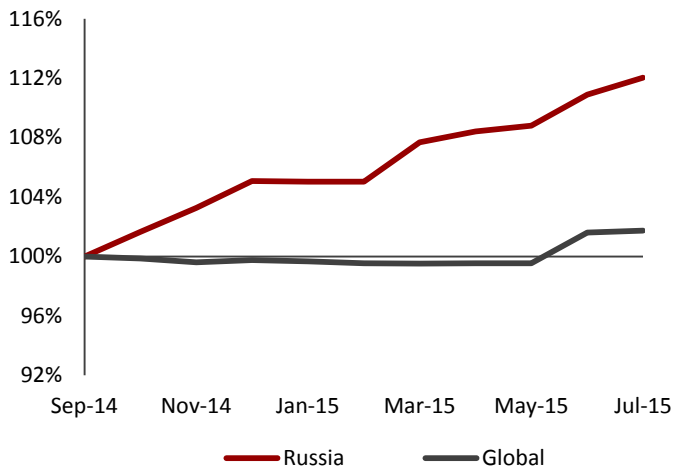


### Gold & Copper Industry

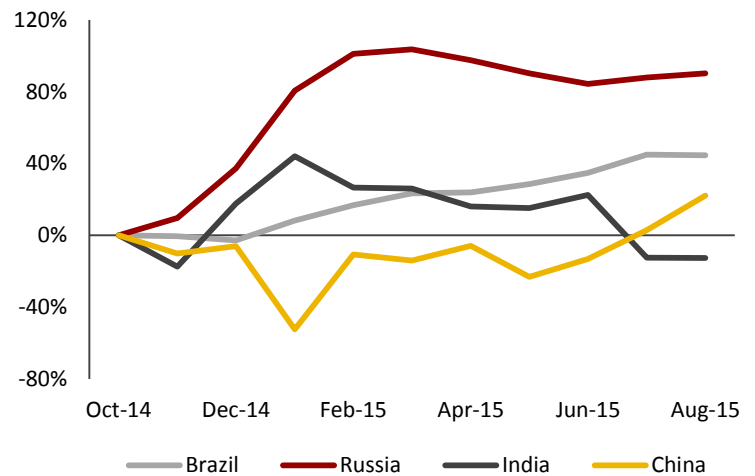
Two of the main overarching fundamental reasons for investing in gold are the fear of inflation, and the belief that gold will hold its value better than cash. When we initially entered our position in McEwen Mining, a mid-size gold and silver producer in the Americas, we had outlined several underlying macroeconomic factors that we felt would drive gold price higher throughout 2014 and 2015. These factors included continued bulk purchases of gold by central banks, particularly Russia, sluggish global growth, elevated geopolitical risk around the world, increasing money supply in the US, as well as the continued rise of inflation within emerging countries (see Figures 2 and 3). Although many of the underlying conditions usually associated with a gold rally were indeed present during 2014 and 2015, gold price continued to slump, closing 2015 at \$1061 an ounce, down 10% for the year, and down 45% from its all-time high of \$1922 in September 2011.

## 2015 Materials Sector Review

**Figure 2: Central Banks' Gold Reserves**



**Figure 3: Rising Inflation in BRIC Countries**



Not surprisingly, many gold mining companies have struggled in the recent low gold price environment, particularly producers with high all-in sustaining cash costs. Many miners faced the dilemma of staying operational while losing money or incurring the costs of closing operations, while waiting to restart operations under more favorable market conditions. Furthermore, many miners were forced to recognize impairments in the value of their mines due to the low price of gold.

Given these challenging market dynamics, several precious and base metals miners divested non-core assets in an effort to clean up their balance sheets. While 2015 mergers and acquisitions activity was relatively subdued, we expect M&A activity to pick up as either smaller players in the industry are acquired, or further divestitures and restructuring occurs.

Although copper prices did go up at the beginning of 2015, we were skeptical given signs of weaker demand from China's construction sector. Taking this into account, we decided to close our exposure to copper by selling Lundin Mining in May. Since then, the price of copper has gone down over thirty percent. We've seen similar performance from other base metals, mainly due to low demand from China and other emerging markets. In the case of copper, the slowdown in China has been a significant obstacle since the country consumes 45% of the world's total supply.

### Forestry & Lumber Industry

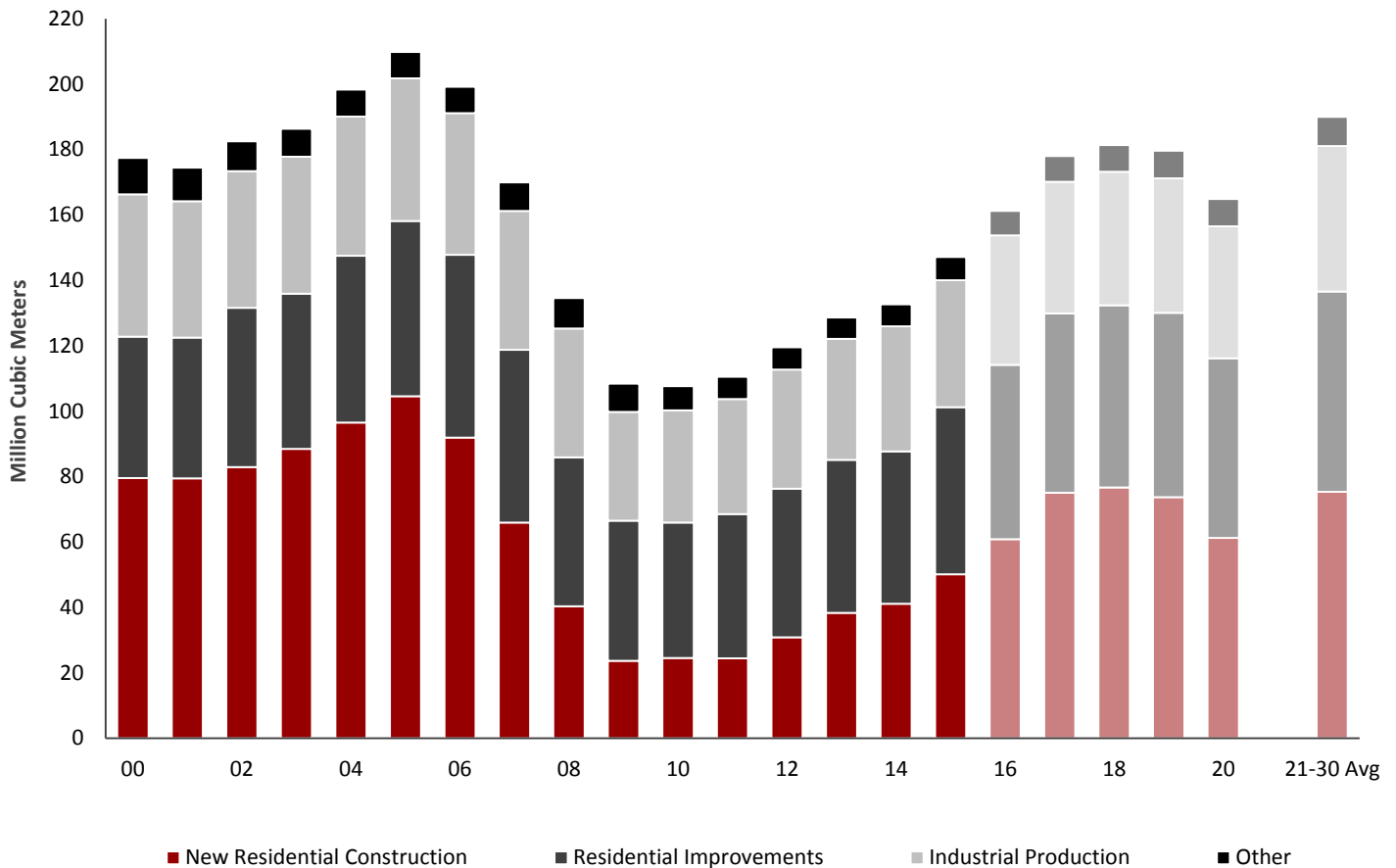
Similar to the performance of metals in 2015, we saw a significant decline in the price of commodity type lumber. Starting in 2015, commodity lumber prices were around \$330 per thousand board feet but fell by almost a third throughout the year due to lower demand. In fact, most of the key drivers causing the downturn in base metals prices with respect to China's decreasing demand were also true for the lumber industry. For the past decade, there have been significant incentives in China to invest in real estate construction because it is necessary to develop properties on the land in order to retain rights to the area. For this reason, hundreds of ghost towns and cities have popped up in China, which drove demand for both metals and wood products. These events largely contributed to the current high level of real estate inventory in the country. Based on the above, we strategically made investments in the subindustries and companies that we believed were less exposed to downturns in the Chinese economy.

Western Forest Products is one of these investments, a lumber and forest products company based out of Western Canada. The company focuses in specialty lumber products and value added products that differ from standard commodity lumber, which only accounts for a fraction of their sales. Despite its sales exposure to China, the company operates in niche markets where commodity prices and demand are more stable than commodity type lumber. Unlike competitors, the company also benefits from a flexible operating platform whereby it can quickly adjust to market conditions and change the focus of production, or use the lumber in producing other products that can provide better

## 2015 Materials Sector Review

provide better value. Despite a poor year for lumber prices, the company was still able to report record pricing because of its flexible platform and its ability to differentiate itself from other lumber companies by having strong niche lumber product offerings that differs from commodity lumber.

**Figure 4: US Historical and Forecasted Wood Products Consumption by End-Use**



While we have not seen favorable conditions in China, there has been a pick-up in construction activity in the United States. One noticeable trend in 2015 was the renewed strength in the number of housing starts which are slowly but steadily converging to pre-crisis levels. Given the current recovery in the American housing market, demand for wood products is expected to increase significantly as we head toward the end of the decade. The repair and remodeling segment of the housing construction industry represented a dominant portion of the overall demand for wood products in the US. As we head toward 2016, we expect the repair and remodeling segment to continue on a growth trajectory but to be outpaced by new housing starts in terms of share of overall demand for US wood products.

All in all, while there are diverging trends around the world for the demand of lumber used in construction, we are confident in our investment in Western Forest Products given the fact that the company has shown the ability to exceed market expectations by increasing its average realized lumber sales price despite headwinds in the commodity lumber market.

## 2016 Materials Sector Outlook

### DCM Materials

Looking ahead, we expect 2016 to be another challenging year for the materials sector, particularly for the base metals space. As most commodity prices are likely to remain at depressed levels going forward, growth in resource-focused economies isn't promising. The next 12-18 months, however, will be a pivotal period during which some commodities, such as copper, will bottom out and even be supported by lower supply due to price-related mine closures following the extended low commodity price environment.

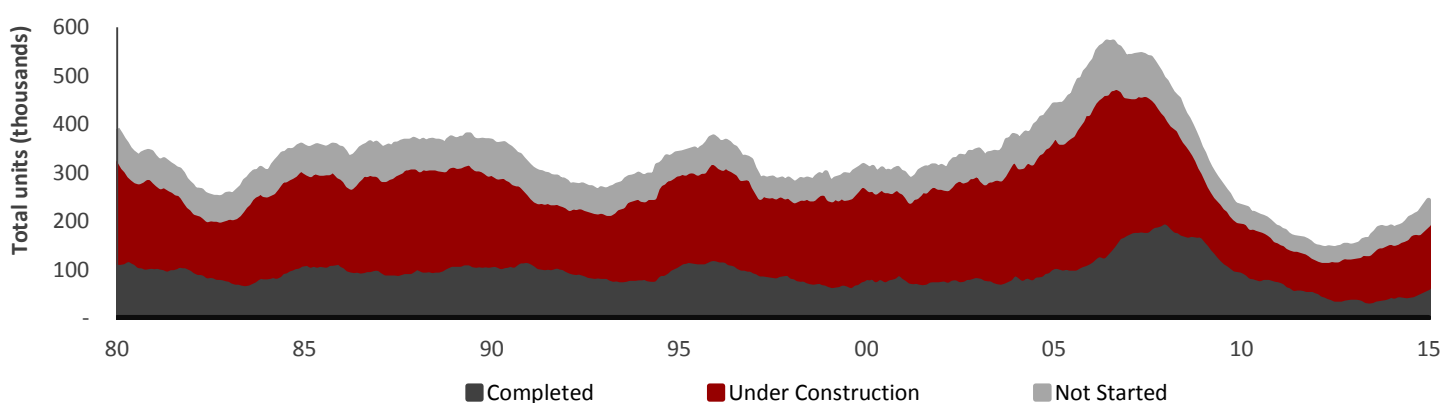
Given this challenging environment, some of the key areas of focus for miners have been cost reduction initiatives, delayed capital expenditures, restrained exploration budgets, price-related mine closures, production cutbacks, and balance sheet deleveraging by divesting non-core assets. Examples of these measures can be seen from strategic decisions taken by players like Rio Tinto Mining who sold one of its non-core assets at the beginning of 2015 or Anglo American who recently announced a significant cut in its employee base.

We expect these initiatives to continue into 2016 and provide opportunities for companies with a strong cash position, robust cash flow generation and low leverage to acquire assets on the cheap and improve their production profile or projects under development pipeline. Given the distressed situation of many players in the field, the urgency of reducing debt levels and the difficult fight to maintain manageable liquidity levels, we expect to see healthier producers benefit from opportunities to acquire assets at attractive valuations. That being said, we expect M&A activity to increase going forward, as miners try to find ways to improve their balance sheet positions or seize opportunities to enhance their asset portfolio.

### Forestry Industry & US Housing Market Outlook

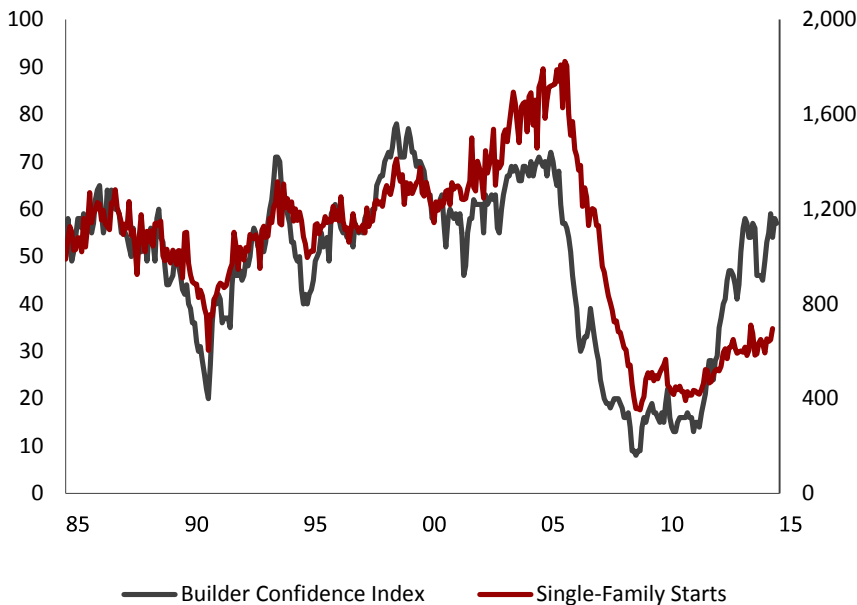
As noted above, we remain bullish on the US housing market, and expect our position in Western Forest Products, a leading Canadian softwood products manufacturer, to benefit accordingly. Below we highlight several factors to support our thesis.

**Figure 5: New Single Family Home Inventories**



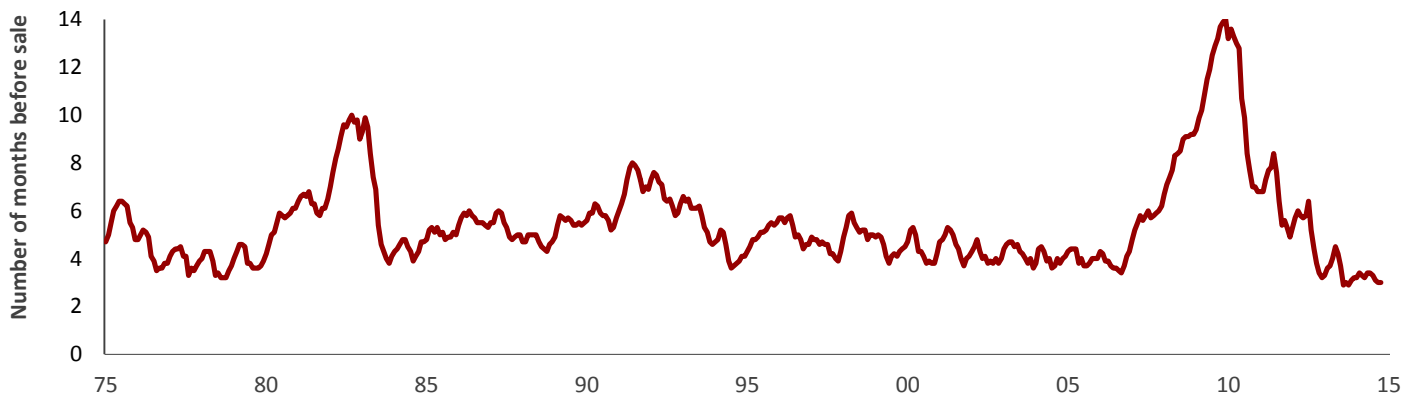
US single-family home inventories have reached historical lows following the crisis. In the few years preceding the housing crash, we saw historical high levels of inventory which were fueled by strength in homebuilders' confidence who kept on building housing developments despite a decreasing demand. The crisis put a halt to the activity of a majority of the American builders and inventory started to decrease between 2009 and 2013, reaching historical lows. Post 2013, builder confidence has gained traction and inventories are climbing back toward normal levels. Since the beginning of 2015, we have witnessed inventories at a level of 216,000 units, still significantly lower than any other cyclical lows of the last 40 years. We expect inventories to revert back to the historical average of approximately 350,000 units, fueled by higher level of housing starts.

**Figure 6: Single-Family Starts Lagging Builder Confidence**



Another key indicator of future housing development in the US is the gap between the level of single-family starts and the Builder Confidence Index. Historically, the two indicators had strong correlation but ever since the recent crisis, a sizable gap has emerged. We foresee a gradual reduction in this gap in the short to medium term as housing starts pick up in the US. A metric we also find important is the number of months needed before newly built homes are sold. This measure is a great way to gage the demand side of the equation in the housing market. In the midst of the housing crises, new homes were selling at an historical high of about 14 months after completion. In 2015, the indicator shows that new homes are selling quicker now than they were in the past 40 years, illustrating a significant pickup in demand.

**Figure 7: Completed New Homes Are Selling Quickly**



**Figure 8: Housing Starts Below Underlying Demand**

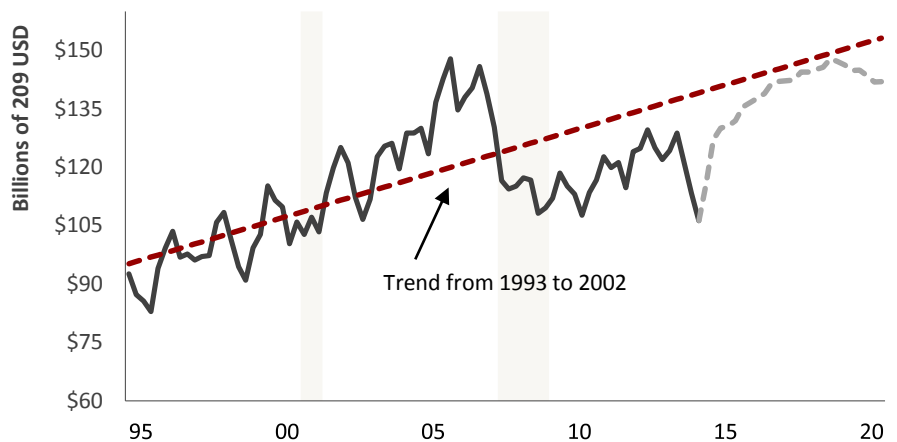


Figure 9 further highlights the current undersupply of houses in the American housing market. We expect the strong current demand for new homes to drive housing starts and expect to see the supply and demand gap slowly closing in 2016 and 2017.

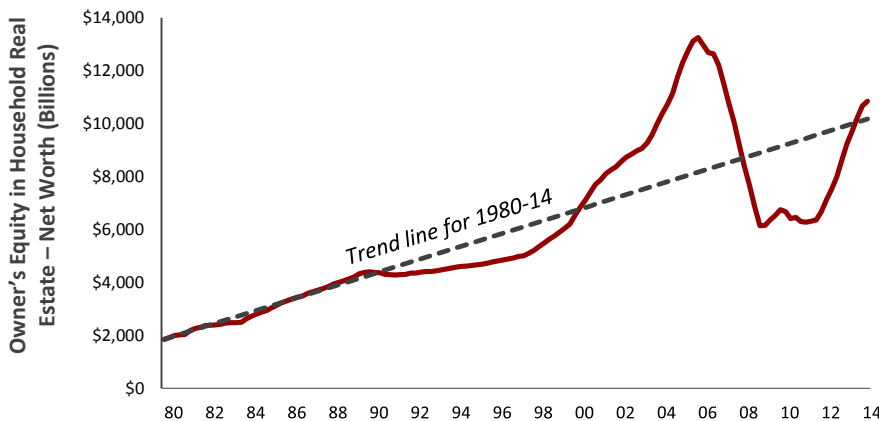
# 2016 Materials Sector Outlook

**Figure 9: US Home Improvement Expenditure**

Another key indicator of a recovery in the American housing market is the strength of home repair and remodeling activities. Residential improvements and remodeling, which significantly slowed down around the crisis are expected to revert back to their long-term trend by 2018. R&R spending is forecasted to grow by 4.5% between 2014-18 compared to 1.2% between 2009 and 2013.

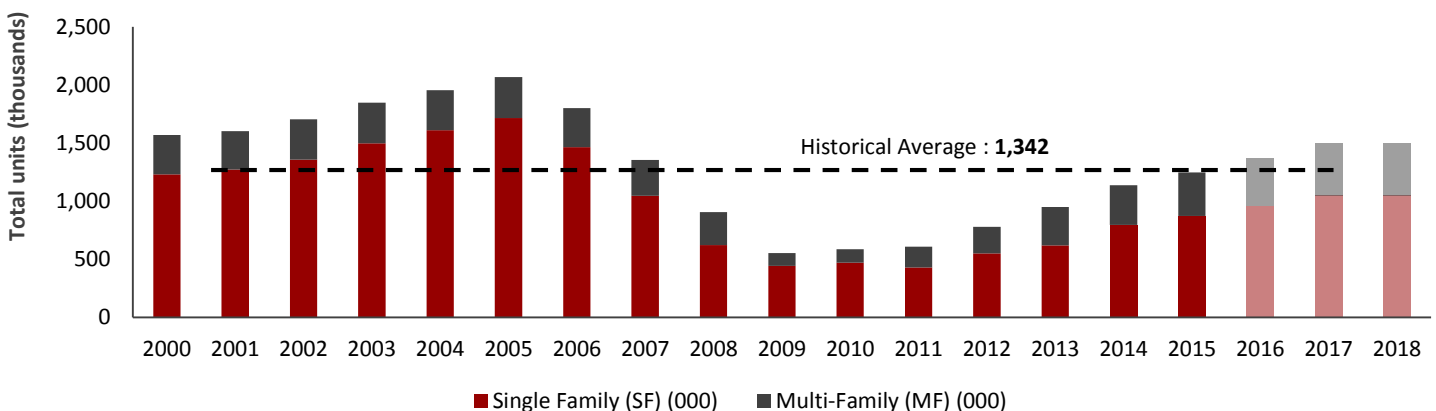


**Figure 10: US Home Equity Now Exceeds Long-Term Trend**



The owner's equity in household real estate is a great measure of the strength of American households' balance sheet. We see that households' home equity has increased by more than 70% in 2012. This increase in home equity was notably fueled by a 24% increase in home prices from 2012 to the end of 2014. We expect higher household equity level to drive improvement and remodeling activities going forward.

**Figure 11: Historical Housing Starts and Forecasts**



The above figure provides insights on the historical levels of both multi-family and single-family starts in the US market. Considering the indicators discussed above, we expect a full recovery in the housing market in 2016-17 with the continued increase in overall housing starts reaching and surpassing the historical average of 1,342K annually. We believe our portfolio is well positioned to benefit from these favorable industry drivers.

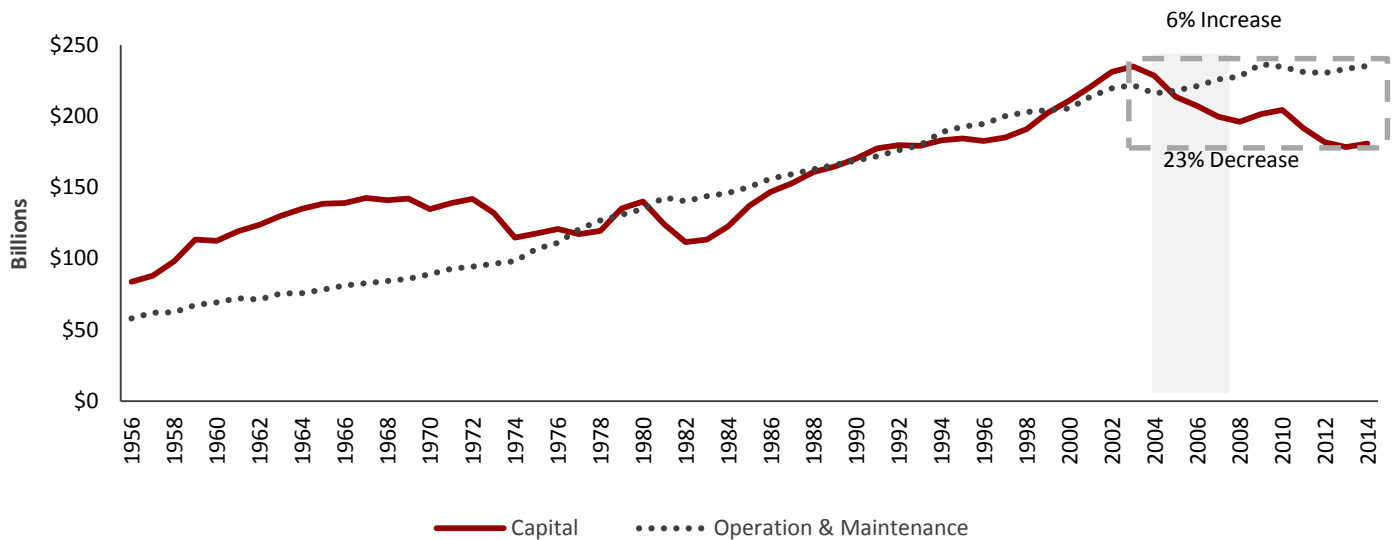


# 2016 Materials Sector Outlook

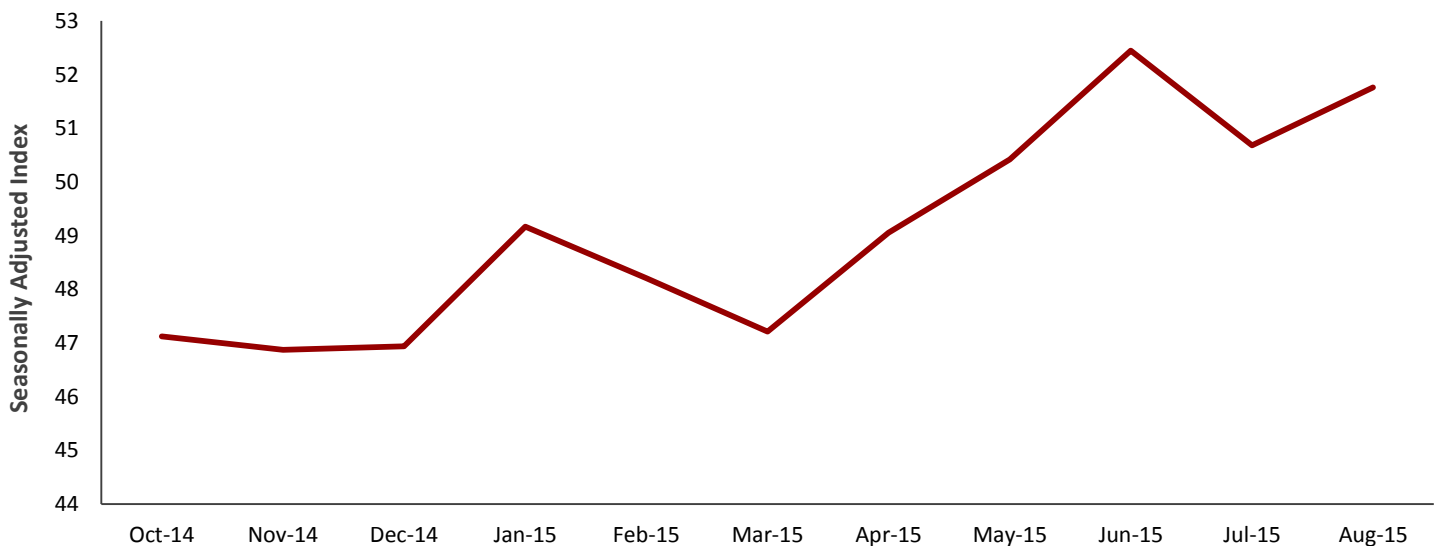
## Building Materials Industry Outlook

Following the financial crisis, there was a significant decline in capital spending on transportation and water infrastructure. Instead of capital spending, there was a bigger focus on operational and maintenance related spending to make sure the existing infrastructures in place were operational. This led to a significant amount of building backlogs, not only in public infrastructures, but also in other commercial projects. All in all, with the passing of the Fixing America's Surface Transportation Act in December 2015, we expect a lot more steady funding by the Federal government through to 2020 that will allow states to commit to long-term projects which they had not been able to do previously given that past bills had short term focus with less than two year funding horizons. We see this as a strong driver for construction activity starting in 2016. And will be looking for investment opportunities in this industry.

**Figure 12: Public Spending on Transportation and Water Infrastructure**



**Figure 13: PMI Building Backlogs of Work**



# Materials Sector

Holdings Review



# Western Forest Products (TSX: WEF)

## Company Overview

- Western Forest Products is a Canadian softwood products company operating in the coastal region of British Columbia. The company is primarily engaged in timber harvesting, reforestation, forest management and value-added wood products remanufacturing.
- The company owns 7 sawmills representing more than 1.1 billion board feet of production capacity and 2 remanufacturing plants which make WEF the largest crown timber tenure holder in Coastal B.C., as well as the largest cedar lumber manufacturer in North America.

## Catalysts

- Continued recovery of the US housing market driving demand for Canadian wood products
- Favorable lumber/log demand and prices
- Sustained strength of the USD relative the CAD
- Capitalization on current opportunities to capture greater market share in the North American and Asian markets

## Risks

- Higher input costs and potential supply restriction from the Canadian government
- Changes in lumber/log demand and prices leading to a decrease in forecasted top line growth
- Slower recovery of the US housing market

## Financial Summary

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

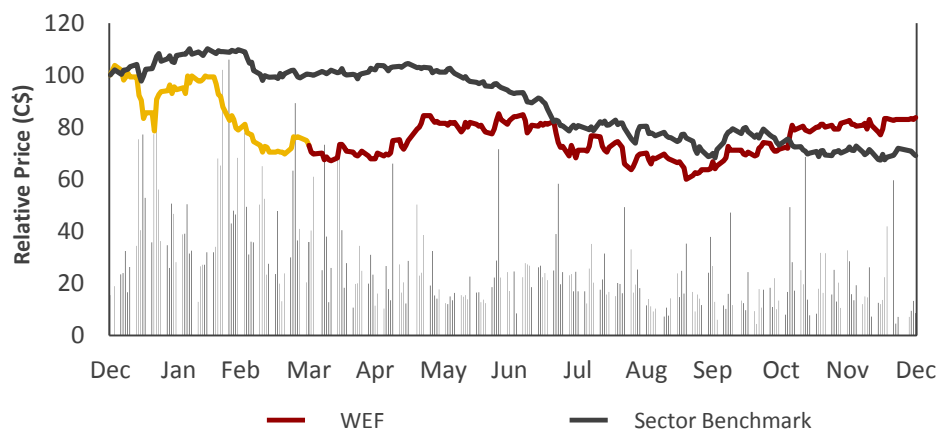
Share Price	\$2.26
S/O (mm)	395.1
<b>Market Cap.</b>	<b>\$892.8</b>
+ Total Debt	\$73
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$15
<b>Enterprise Value</b>	<b>\$951.1</b>
Beta (1-Year)	0.85
Dividend Yield	4.4%
52-Week High	\$2.80
52-Week Low	\$1.62

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$1,049	\$1,138	\$1,154
% Growth		8%	1%
EBITDA	\$96	\$142	\$152
% Margin		12%	13%
EPS	\$0.10	\$0.25	\$0.28
% Growth		150%	14%
EV/EBITDA	9.9x	6.7x	6.3x
P/E	23.0x	9.2x	8.1x
P/Sales	0.9x	0.8x	0.8x

## Normalized Stock Price and Sector Benchmark Performance



## Position Snapshot

Average Cost	\$1.98
# of Shares	36,191
Value Invested	\$81,792
Portfolio Weight	2.87%
2015 HPR	14.7%
HP Benchmark Return	-31.1%
Excess Return	45.8%

All figures in CAD

Benchmark: 40% SPDR S&P Metals & Mining ETF (XME), 60% iShares S&P/TSX Capped Materials Index (XMA.TO).

# Western Forest Products (TSX: WEF)

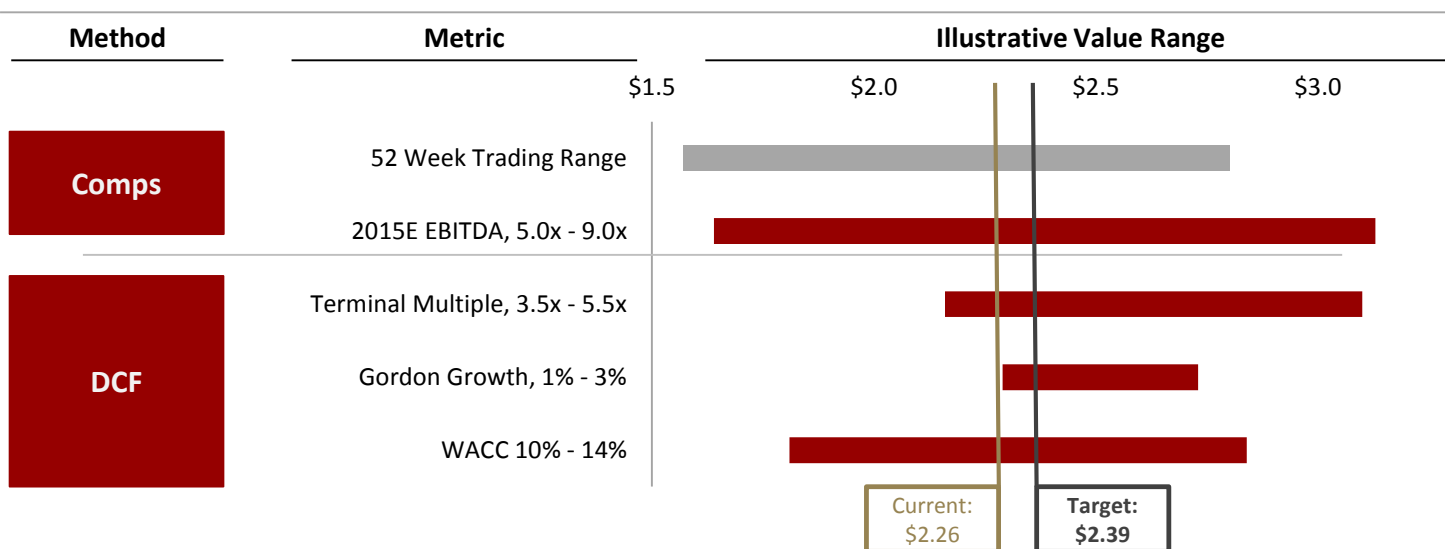
## Investment Thesis

- 1. Industry tailwinds and favorable macroeconomic trends:** *The Canadian forestry industry is set to benefit from the recovery of the United States housing market which is expected to be fully realized within the next couple of years. Current macroeconomic dynamics yield opportunities for Western Forest Products to capture a greater market share in the North American & Asian markets.*
  - The mountain pine beetle infestation is affecting the production levels of WEF’s main competitors, which enables the co. to capture greater market share in its key geographies
  - The company focuses on growing its share of the WRC markets in the U.S., which continue to show signs of increasing demand fueled by a strong repair and remodeling activity
  - The strength of the USD relative to the CAD makes Canadian lumber very attractive to U.S. buyers while significantly increasing the company’s profitability
- 2. Flexible revenue structure and strong financial position:** *We believe that Western Forest Products’ strategy, which focuses on superior quality, higher margin and less volatile specialty products in terms of demand and pricing fluctuation, is overlooked by investors*
  - Diversified & flexible revenue structure both geographically and by product type allows WEF to direct resources to the highest margin opportunity and lowers the company business risk
  - The company benefits from a strong balance sheet with significant hard assets, high liquidity and industry low leverage
  - We expect the company’s margin focus strategy & recent strategic capital investments to strengthen the company’s operating margin going forward
- 3. Attractive Valuation:** *WEF is trading at a discount to peers on a P/E and EV/EBITDA basis despite a more conservative capital structure, stronger operational flexibility, strong growth prospects, and lower risk profile. We do not believe that WEF’s fundamentals call for such a discount and expect the valuation to converge to peers’ level.*

## Analysis of Performance

We initiated our position in Western Forest Products at the end of March 2015, at a price of \$1.98. Since the beginning of our holding period, the company has delivered strong quarterly results, achieving record Q3 lumber revenues despite a 20% decline in commodity lumber prices. The company was able to leverage its flexible revenue structure to increase sales volume of specialty lumber products which have higher pricing stability. As of the end of the reporting period, our position returned 14.7%.

## Valuation Summary



# Health Care Sector

2015 Review & 2016 Outlook

*By Naomie Gendron and Meagan Prins*

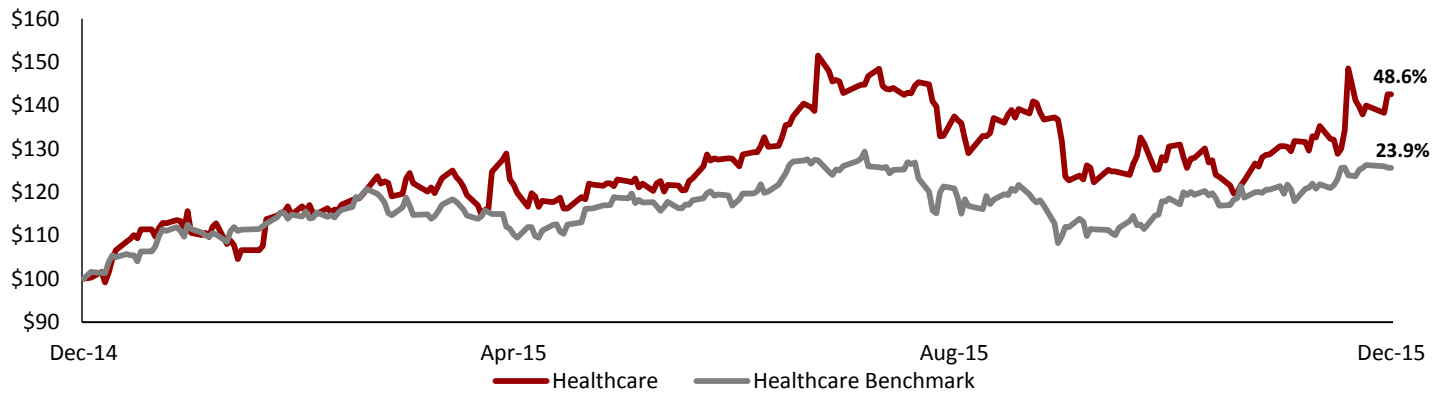


## 2015 Sector Performance

DCM's Healthcare Sector had another very strong year in 2015, returning 48.6%, some 24.7% above our sector benchmark. Notable performers included Vascular Solutions and CRH Medical, details of which are provided in the holdings review section.

It was a year of two halves for the healthcare industry. H1 saw large scale price appreciation on the back of an explosion in M&A, while H2 was marked by sky high volatility and legislative uncertainty, which ultimately lead to multiple contraction. Still, Healthcare was the second-best performing sector in the S&P500, second only to Consumer Discretionary.

**Figure 1: DCM Healthcare Performance**



Benchmark: 100% iShares US Healthcare ETF (IYH)

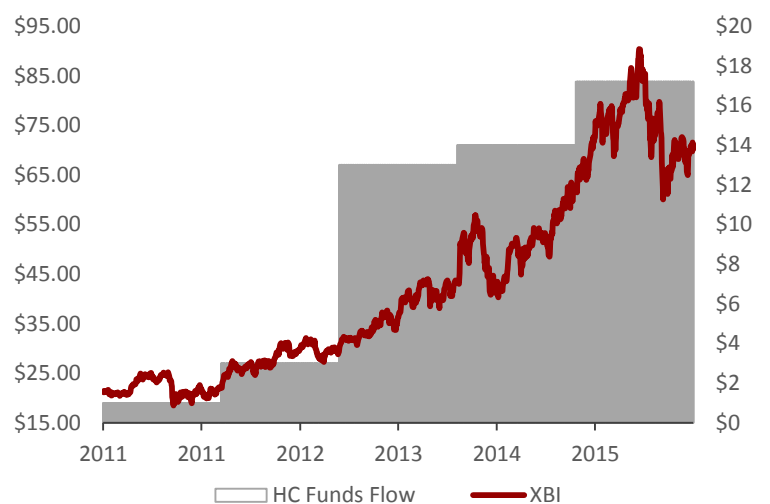
## 2016 Sector Outlook

Going into 2016, we have our eye on a number of catalysts, including a wave of innovation running through the sector. However, the optimism is mitigated to an extent by growing and pressing policy risk correlated with the upcoming presidential election. Consensus estimates have earnings growth down slightly in 2016, but still at healthy double-digit levels. Below is a review of what we anticipate will be the important investment themes for the sector in 2016.

### Shadows of a Biotech Bubble

Over the past year, concerns of a biotech bubble have been raised, with IPO exit opportunities and M&A activity fueling valuations. Indeed, biotech has outperformed for the past five years. Not only did existing biotech stocks fly higher, but new biotech companies appeared at a furious pace. From mid-2011 to mid-2015, the XBI biotech ETF more than quadrupled. This trend tends to correlate with growing capital inflows from investors. It only had one significant correction, in early 2014, before doubling yet again. But the bull abruptly stopped last summer. We find the parallels to the internet bubble striking, where prices of unprofitable companies also soared and venture capital funding was readily available. Similarly, investors have recently committed billions on speculative pharma companies that lack any track-record or serious potential ability to produce a viable

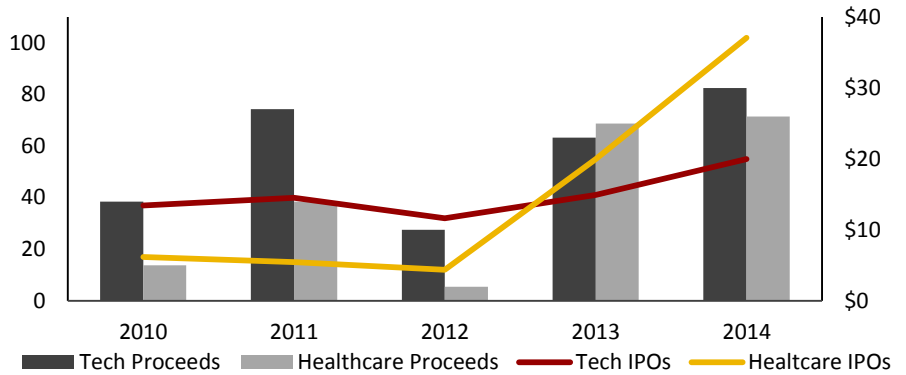
**Figure 2: Biotech Performance Against Funds Flow (\$B)**



## 2016 Outlook

drug. Although, regular tech IPOs have still outgrown those of the biotech sector in dollar terms, the latter is exploding. In fact, in 2014, one in four of all U.S. IPOs were biotech deals. The positive sentiment surrounding the biotech sector seems relentless so far. Of course, many of the high-flying e-start-ups that went public came crashing down. Post-IPO performance of biotech stocks exhibit a similar pattern. In 2014, the average first day IPO return was 13%, and one-year returns were 25%; however, longer-term prospects are less favorable.

**Figure 3: Biotech is Outgrowing Tech in Deal Flow**



Data from IPOs tend to confirm that the risk of valuations spiraling down is justified, with a post-IPO four-year average performance coming in at -6.5%. Post-IPO returns do exhibit a declining pattern, with a two-year, three-year and four-year performance of respectively 5.0%, -36.2% and -11.6%. Also, cause for concern is that roughly 70% of biotech companies that have gone public have done so with either preclinical or phase 1 or 2 assets only, while 97% of drugs in preclinical tests never make it to market, as is the case with 95% for phase 1 and 88% for phase 2.

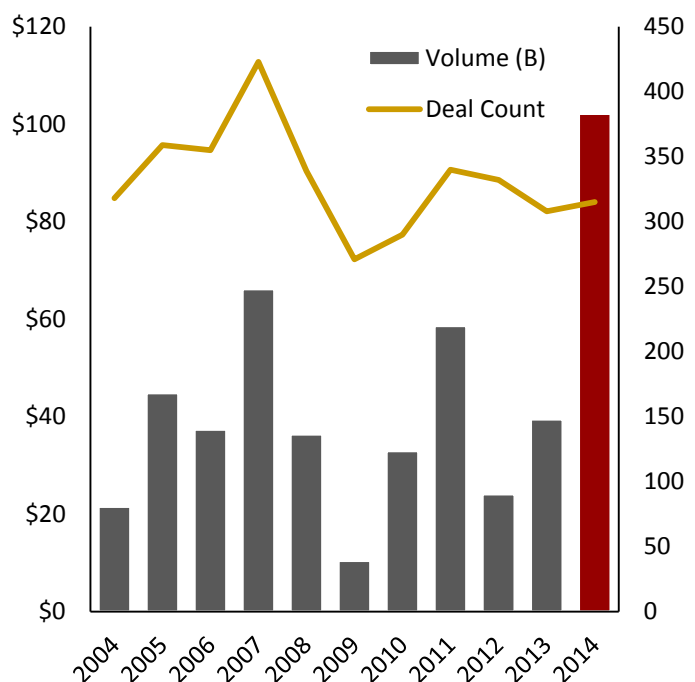
Within biotech, given the current market environment, we currently favor large companies that have a proven and well-diversified drug portfolio

## Adventuring Outside the Drug Landscape

Given the idiosyncratic nature of biotech as well as the policy risk associated with big pharma, DCM actively seeks investment stories within safer sub-sectors characterized by stable return profiles.

**1. Medical Devices:** Large-cap medical device stocks (IHI US) outperformed the S&P500 by 8.1%, returning 9.0% for year-end 2015. Despite the fact that it represents the sector's weakest annual returns since 2011 (2012: 13.2%; 2013: 34.4%; 2014: 22.9%), we expect a turnaround in 2016. The relatively lower returns are arguably attributable to companies having to adapt to structural changes, particularly the implementation of the 2.3% medical device tax under ACA. Going forward, we anticipate the sector to perform well given lower levels of uncertainty surrounding regulatory risk and expected ground-breaking innovation. Indeed, consensus estimates that the sector is poised to increase EPS as much as 11% on a 7% sales growth. Diversified device makers such as Boston Scientific, St. Jude Medical, Edwards Lifesciences, Medtronic and Stryker are expected to launch multiple new products in 2016. This anticipation seems to already be priced in. Indeed, medical device companies trade at a premium to the S&P500 companies, on a NTM P/E basis, due to, we believe, the strong sales and EPS growth expectations.

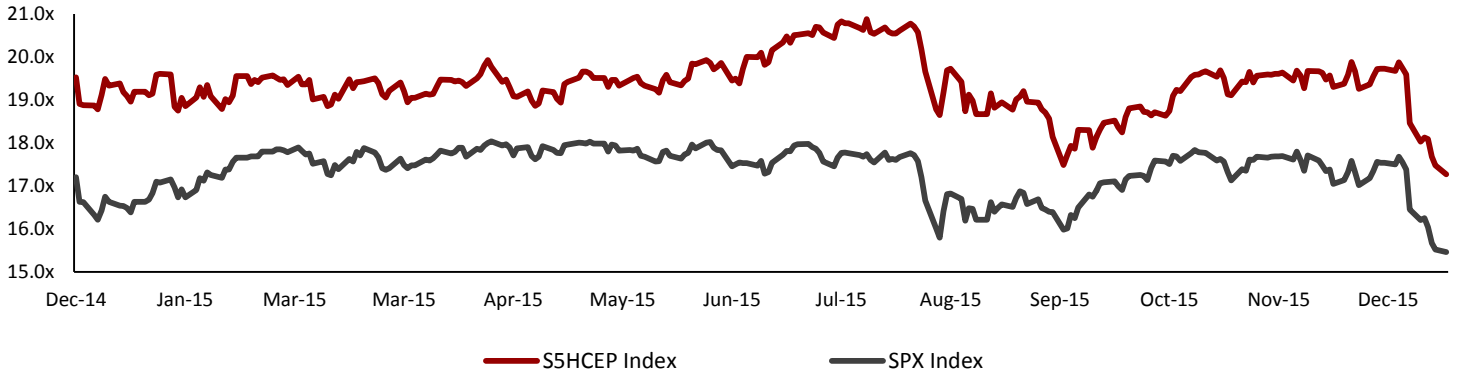
**Figure 4: Medical Devices M&As**



## 2016 Outlook

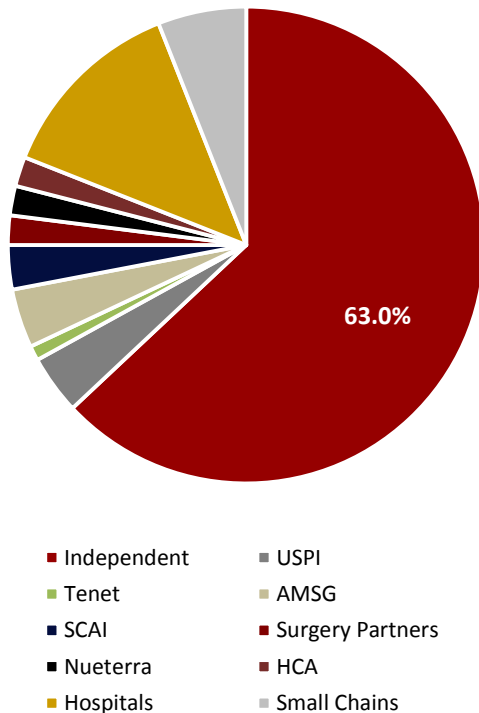
In late December, DCM started liquidating its position in Vascular Solutions (see individual holdings review for more details). Since then, the fund has actively sought out attractive investment opportunities in the space, but has come to the conclusion that they are limited. Indeed, in addition to strong fundamentals drivers, the recently high level of M&A activity has also contributed to push valuation upwards. Thus, DCM will rather focus on medical services.

**Figure 5 : Forward P/E Ratio**



**2. Medical Services:** The implementation of Obamacare has undoubtedly served as a tailwind for hospitals thus far. However, we anticipate the boosting of EBITDA due to further Medicaid expansion to be marginal as 12M additional people have already gained coverage since 2013, with the Congressional Budget Office projecting peak coverage at 14M by 2020. Nevertheless, we see investment potential within this sub sector and the reason is two-fold. An aging population combined with an improving economy should boost revenue.

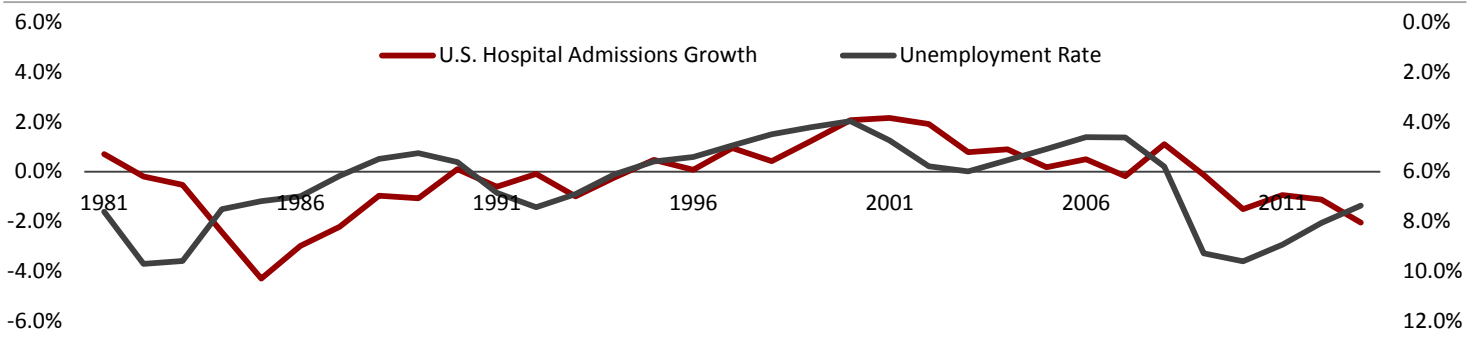
**Figure 6: Players Within ASC Industry**



As shown above, a declining U.S. unemployment rate tends to correlate with an increase for medical service utilization. Further, we consider the two-year postponement of the Cadillac tax to be a tailwind for medical services. The Cadillac tax, which is expected to take effect beginning 2020, represents a 40% excise tax that will be imposed on employer-sponsored insurance plans. Consequently, the healthcare industry will be affected: both as a provider of services and as an employer. In an attempt to reduce costs, employers will offer less generous health plans, which in turn should reduce healthcare utilization. Therefore, it is our opinion that people will try to take advantage of their current plans, increasing the rate of utilization of medical services presently and through until 2020. However, it is to be noted that it seems more likely that the tax will never take effect. Both Democrats and Republicans have been pressured to repeal the tax by unions and businesses, respectively. Yet, there is still a shred of uncertainty around the final outcome, which will compel people to get medical care sooner rather than later. As such, DCM will focus on finding investment stories within the Ambulatory Surgical Centers (ASCs) space. ASCs are outpatient facilities providing same-day surgical care. For instance, one could get his colonoscopy done at a gastroenterology (GI) center. Moreover, although no investment thesis should rely solely on an M&A argument, it is certainly an area worth noting. Within the hospital industry, consolidation is expected to be focused in the outpatient and physician services settings. The reason for this is two-fold. Firstly, the market for ambulatory surgery centers is \$24B and is highly fragmented. Secondly, EBITDA margins tend to be higher relative to acute care hospital (22% vs 15% respectively), which ease access to financing.



**Figure 7: Hospital Admissions Increase when Unemployment Decreases**

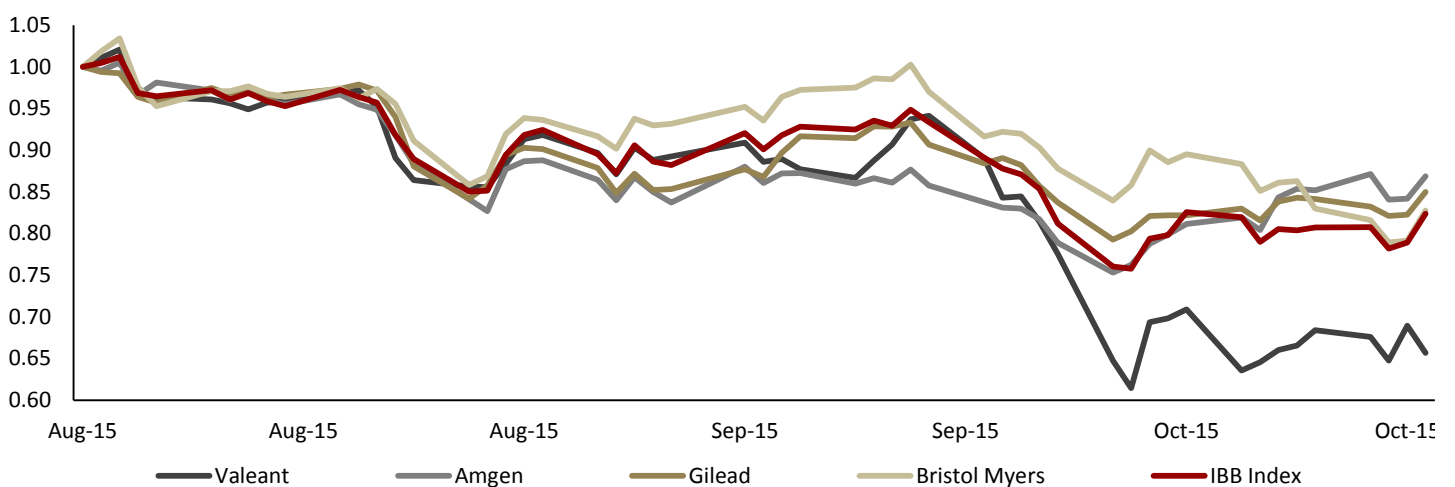


## Specialty Pharma

According to IMS Health, the largest Healthcare consulting firm, specialty drug spending accounts for approximately a third of overall U.S. prescription drug spending. The magnitude of the sub-sector can't be overlooked.

**1. Election Focus on Drug Pricing:** Since Clinton's tweet criticizing drug prices on Sept. 21st, pharmaceutical companies have received considerable attention surrounding the prices they charge for prescription drugs (see chart below). In the upcoming months, the scrutiny is unlikely to ease off and pharma stocks could come under further pressure as politicians try to score more points with voters. It is also worth noting that for years the pharma lobby has successfully prevented the occurrence of the vast majority of proposals that would cut into their profits. Nevertheless, we acknowledge that recent changes in regulation could adversely impact the pharma industry, from the perspectives of both manufactures and patients. Back in late October 2015, the Senate passed the Bipartisan Budget Act of 2015, which amends the Medicaid Drug Rebate Program to impose a price increase penalty on branded as well as generic drugs. As such, a company whose prices rise faster than the rate of inflation, will pay an additional rebate to the Medicaid program. Further, beginning on April 1st, 2016, Medicaid agencies will start reimbursing pharmacies for prescription drugs based on actual acquisition costs rather than based on the ingredients costs and dispensing fees. The government believes this new reimbursement methodology is a more accurate measure of the true cost. Despite appearing cost efficient for the government, the Covered Outpatient Drugs (issued by the Centers for Medicare & Medicaid Services) could result in either increases in the patients' share of drug cost or could pressure the manufacturer to cut their prices as pharmacy benefit managers (PMBs) try to pass along this burden.

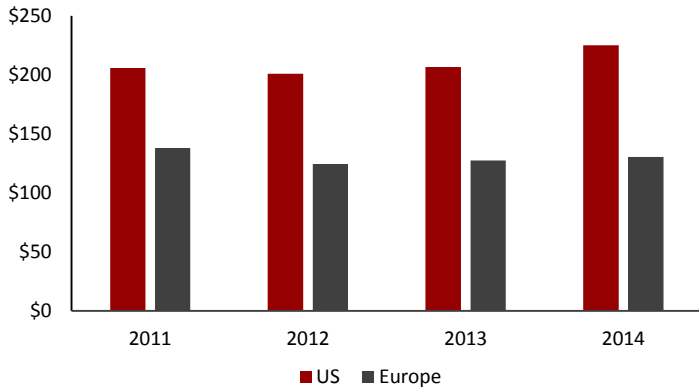
**Figure 8: \$10B Haircuts**



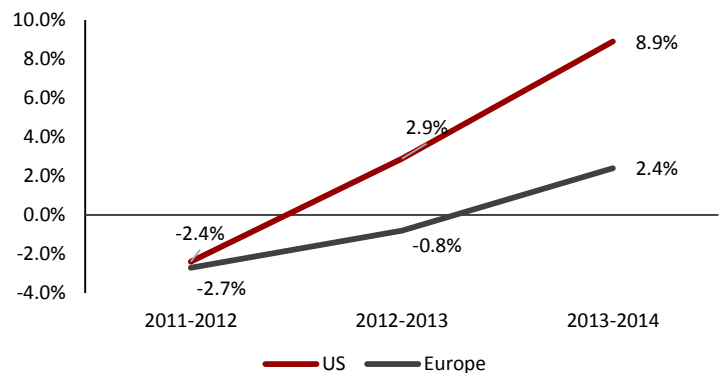
## 2016 Outlook

**A. Case Study Europe vs. U.S.:** We expect drug prices to be a major issue in the presidential race but do not expect any new legislation to pass under the current Republican-controlled Congress. Nevertheless, in an attempt to evaluate the potential risk of such a regulatory change, we reference the European environment, where prices have been regulated for years, as a proxy for the potential impact on the U.S. if regulation were to be vamped-up. Below are time series of prescription drugs sales in both absolute and relative terms, highlighting the headwind effects of increased regulation.

**Figure 9: Regional Prescription Drug Sales (\$B)**

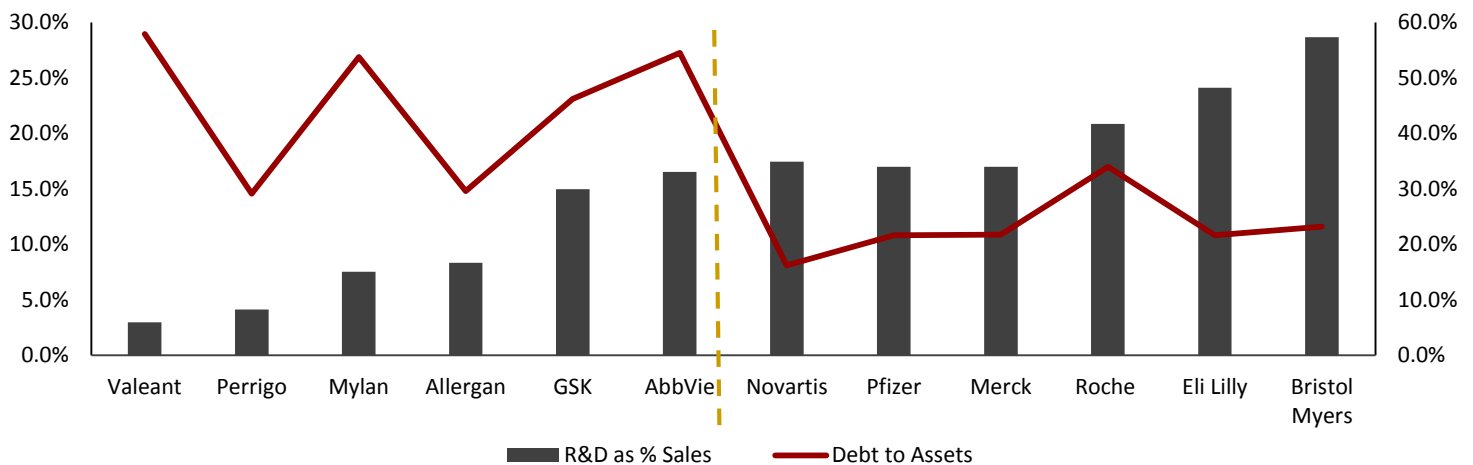


**Figure 10: YoY Growth in Prescription Drug Sales**



**B. Buy to Grow Model Under Attack:** Unlike most drug makers who rely on scientists to develop new drugs, companies like Valeant rely on bankers to find other companies marking drugs it wants. Valeant's R&D spending represents only 3% of sales, compared to a 14% sector-wide average.

**Figure 9: R&D and Debt Levels of Strategically Different Pharma Companies**



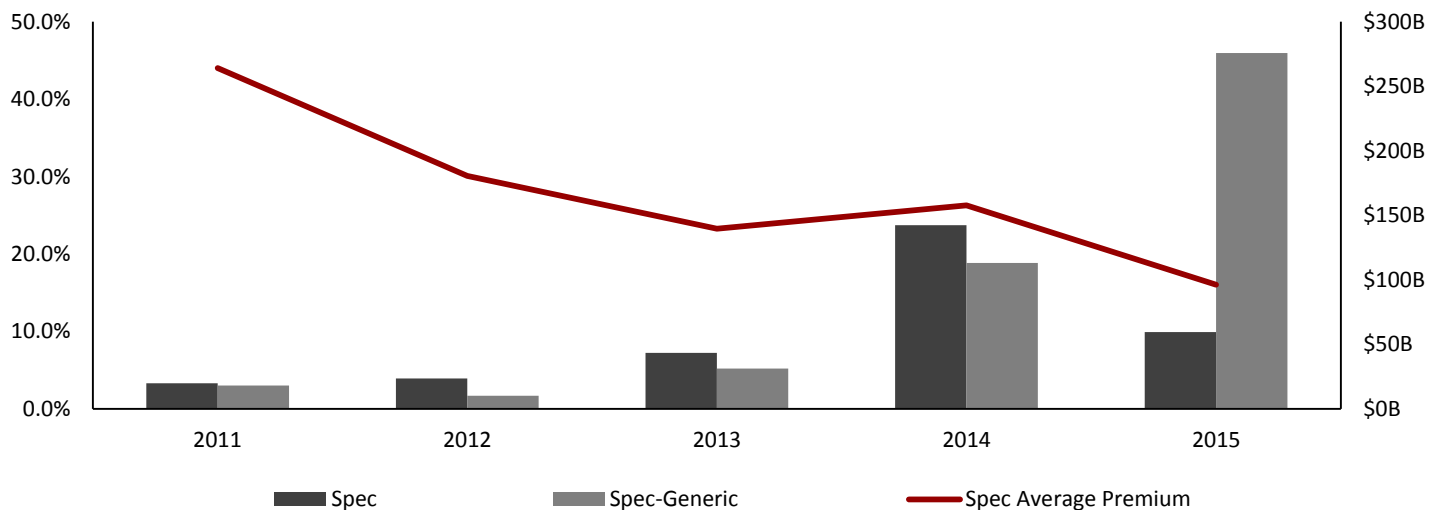
On a superficial level, the Buy to Grow model with low R&D does not sound all that dangerous, since cost containment is a good thing. However, a large debt load is a catch-22 given the fact that a continuously higher leverage level makes acquisition tricky, and yet acquisitions are necessary to bring in additional cash flow to service the debt. This is especially relevant under a potentially tightening regulatory environment, where revenue growth would be driven by volume rather than prices. Valeant represents one high-profile instance where the buy-to-grow model could become precarious. However, other companies such as Retrophi, Horizon Pharma and Endo International also heavily rely on inorganic growth to boost sales. Going forward, DCM anticipates substantial uncertainty surrounding these platform companies. We will thus look to invest in companies that have a balanced mix between internal R&D and M&A and an acceptable debt level that leaves room for flexibility.

## 2016 Outlook

**C. M&A Activity:** In recent years, M&A activity in the specialty landscape rapidly grew to reach a 10-year high in 2014. There are multiple reasons why M&A transactions have been gaining in popularity. Besides being a primary growth engine, greater utilization of these types of transactions result from increasingly inefficient R&D departments of large pharmaceutical companies as well as buyers seeking incremental compensation via M&A and in-licensing deals with specialty pharma companies.

Consequently, this led to continuous upward pressure on premiums, which further drove valuations upward. Going forward, we anticipate this trend to slow. The reason is three-fold. Firstly, tax savings which is arguably one of the main catalysts for the industry, will be harder to achieve given increased scrutiny to restrain inversion deals. Note that last November the Obama administration introduced tighter measures such that a U.S. company must end up with a combined stake of between 60% and 80% of the foreign takeover target in order to qualify for an inversion. As such, it should prevent large players from acquiring small companies for the sole purpose of changing their tax jurisdiction. That being said, in the absence of additional legislation, inversions cannot be stopped completely. Secondly, many of the large targets allowing a U.S. pharma company to relocate its domicile have been taken out. Pfizer recently agreed to the \$160B acquisition of Allergan. In this case, the U.S. firm will own 56% of the new company, falling short of the threshold at which the deal can be legally prevented. Indeed, the deal is simply considered as a straightforward acquisition as opposed to an inversion deal. Thirdly, shareholders have become less receptive to the amounts of debt needed to finance takeovers. As a result of the weaker demand, we anticipate smaller (<\$1B) companies to be taken out at a lower multiple. Further, although we expect pure specialty deals to decrease, we remain cautiously optimistic that lines between specialty and generic pharma will slowly continue to blur, thereby benefiting the generic players from decreased premiums within the specialty segment.

**Figure 10: Specialty Pharma M&As**



In sum, in 2016 DCM's healthcare team will continue to add value by investing in small to medium sized companies, outside the pharma space. Further, we will focus on diversified large cap companies within the biotech sub sector to benefit on inflexions in company specific valuations.

# Health Care Sector

Holdings Review



# Vascular Solutions (Nasdaq: VASC)

## Company Overview

- Vascular Solutions is a medical devices company focused on clinical solutions for coronary and peripheral vascular procedures
- Currently markets 80 products in the catheters, hemostats and vein segments and has 40+ products at various stages of development in their pipeline to ensure future organic growth
- Operates in the US and internationally through 91 direct US sales representatives and established independent distributor network covering nearly 50 countries
- Strong balance sheet characterized by high cash level and no debt gives them the ability to make tuck-in acquisitions

## Financial Summary

## Recent Sale

- We decided to begin exiting our position in VASC and to sell half of our position at \$34.6/share on December 17<sup>th</sup> for the following reasons:
  - Stock rose to a level near our price target of \$37.8 given significant multiple expansion year-to-date, partly arising from its introduction into the SP 600 Small Cap Index
  - VASC's valuation has outpaced its peers, trading at 28.4x EV/EBITDA versus an industry average of 20.3x. The company's P/E ratio also exceeded its 7-year average of nearly 9.0x. At the time of purchase, VASC was heavily discounted on both a EV/EBITDA and P/E basis (17.9x and 36.7x vs. industry averages of 29.7x and 50.1x respectively)
- In summary, the partial realization of our investment thesis (discussed on the following page) along with recent upwards pressure on valuation motivated the sale

### Public Market Overview

(values in \$M, as of Dec. 31, 2015)

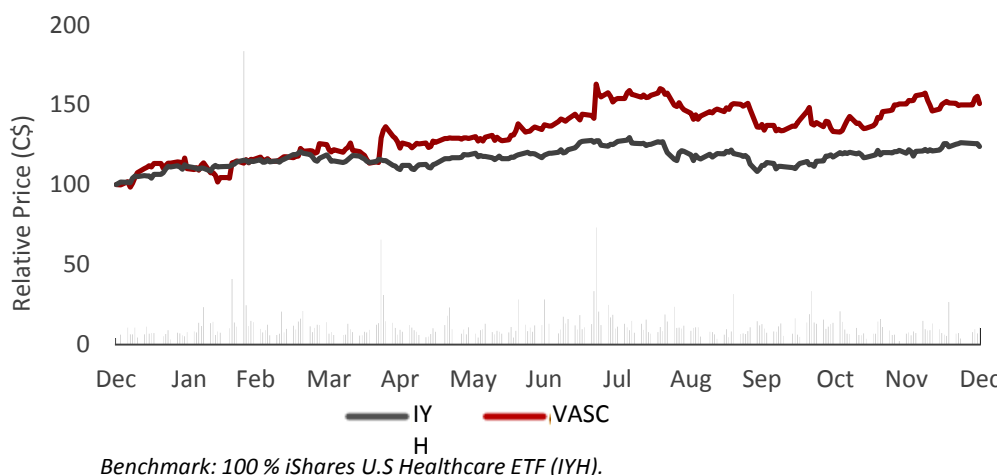
Share Price	\$34.39
S/O (mm)	17.3
<b>Market Cap.</b>	<b>\$596.5</b>
+ Total Debt	\$0
+ Minority Interest	\$0
+ Preferred Shares	\$0
- Cash	\$40
<b>Enterprise Value</b>	<b>\$556.1</b>
Beta (1-Year)	0.90
Dividend Yield	--
52-Week High	\$39.49
52-Week Low	\$25.65

### Financials & Multiples

(values in \$M)

	LTM	FY2016E	FY2017E
Revenue	\$141	\$164	\$183
% Growth		16%	12%
EBITDA	\$32	\$33	\$0
% Margin		20%	0%
EPS	\$0.91	\$1.17	\$1.34
% Growth		28%	15%
EV/EBITDA	17.4x	17.0x	16.6x
P/E	37.6x	29.4x	25.7x

## Market Performance



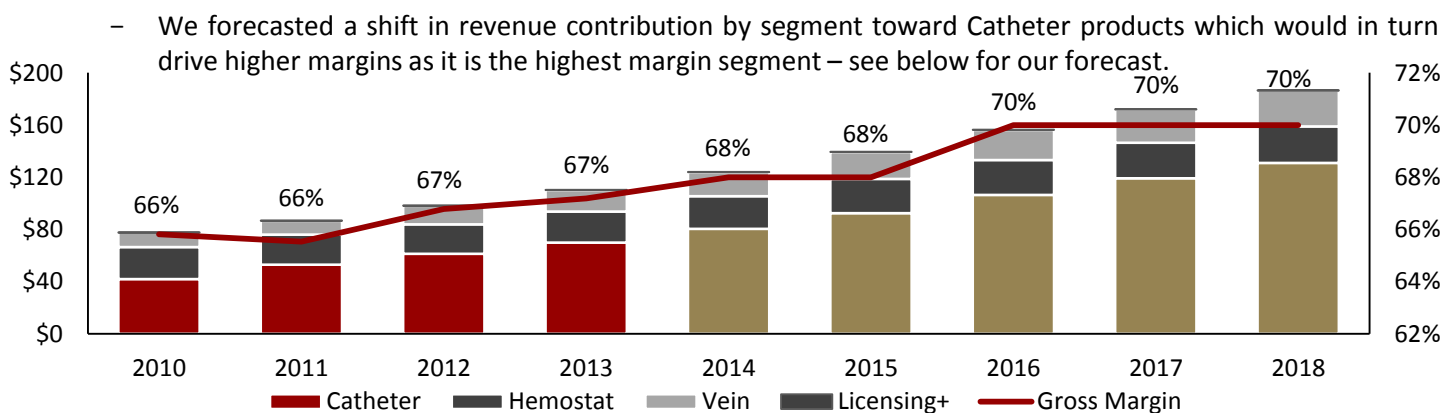
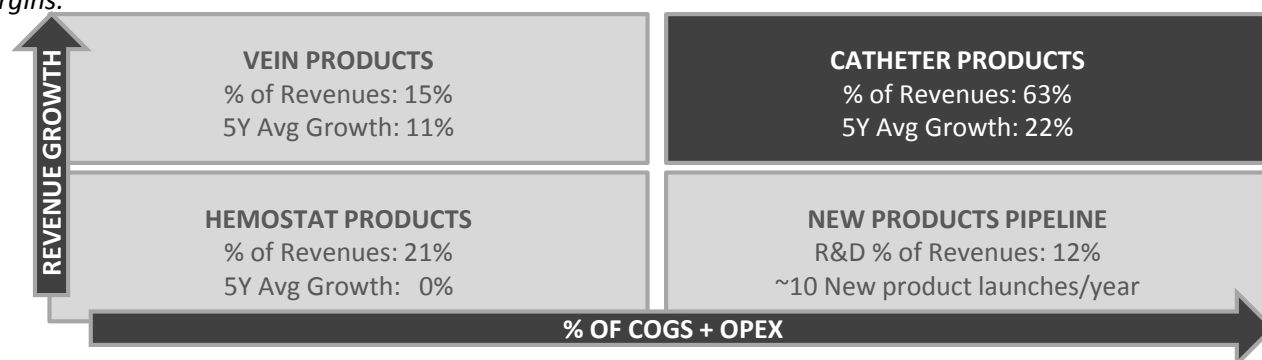
## Recent Volatility

- Note that although VASC's stock has seen substantial upwards pressure in 2015, partly due to increased coverage, recent market volatility has adversely impacted VASC valuation in 2016. As such, we intend on holding onto the remainder of our position until we find a more favorable time to exit.

# Vascular Solutions (Nasdaq: VASC)

## Original Investment Thesis (10/30/2015)

- Internal strength:** *The company was in its 10<sup>th</sup> consecutive year of greater than 10% annual revenue growth in what has been US Healthcare's most turbulent 10 years on record*
  - Hitting lots of singles and doubles wins games: The combination of a steady cadence of new product launches (~10/year) as well as no one product accounting for more than 20% of revenues made the business stable and less subject to regulatory risk
  - Strong margins: The lean business model drove operating leverage such that they were able to grow EPS at a higher rate than revenue growth (4Y average revenue and EPS growth are 12.8% and 22.2% respectively)
- External positioning:** *The company has created a "safe space" within the Medtech space where the industry negatives (excise tax, secular growth) crushing the larger players hardly impact VASC due to unique size, revenue growth and profitability*
  - At the time of DCM's initial entry, we had a greater degree of confidence in the operational benefits of VASC's niche position between small private competitors and Medtech giants than was implied by the share price
- Changing product mix leads to increased margins:** *Management has demonstrated a consistent ability to allocate expenses proportionally to revenue contribution and growth potential as to maximize growth without sacrificing margins.*



## What's Next?

Vascular reported its Q4 earnings on January 21<sup>st</sup>, 2016. Revenue increased 13% YoY, which exceeded the top end of the company's revenue guidance. Further, gross margin increased nearly 100 bps to 67%, which is in line with our initial forecast. Going into 2016, the Russell 2000 Index has been hit harshly, and Vascular fell significantly, hitting a new 52-week low. Our analysis does not warrant such a discount and as such, we will delay the sell of our remaining position until market recovers.

# CRH Medical Corporation (TSX: CRH)

## Company Overview

- CRH Medical is focused on providing physicians with innovative products and services for the treatment of gastrointestinal diseases
- The company delivers clinical, marketing and operational support directly to its partner physicians
- The company is an emerging consolidator and service provider within the anesthesiology services space
- CRH operates in the US and has trained more than 1,700 physicians
- Strong cash position gives the company the ability to expand acquisition strategy

## Position Snapshot

Average Cost	\$3.86
# of Shares	16,200
Value Invested	\$62,480
Portfolio Weight	[5.0%]
2015 HPR	8.75%
HP Benchmark Return	-0.46%
Excess Return	9.22%

All figures in CAD

## Financial Summary

### Public Market Overview

(values in \$mm USD, as of Dec. 31, 2015, except for Share Price)

Share Price	\$4.10
Shares Outstanding (mm)	71.0
<b>Market Cap.</b>	<b>\$291.0</b>
+ Total Debt	\$55.5
+ Minority Interest	\$9.3
+ Preferred Equity	-
- Cash	\$17.7
<b>Enterprise Value</b>	<b>\$338.2</b>

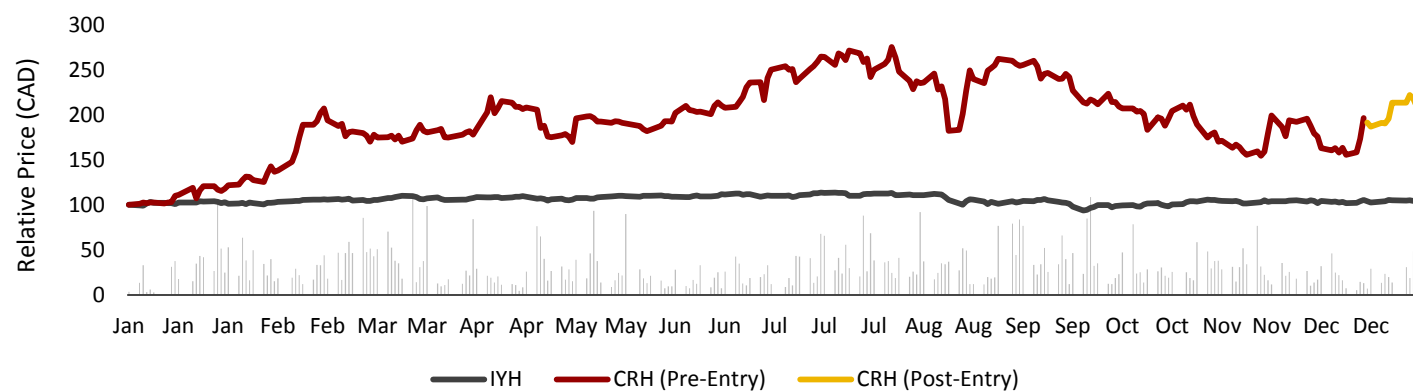
Beta	1.03
Dividend Yield	--
ROE	11.6%
52-Week High	\$5.50
52-Week Low	\$1.98

### Financials & Multiples

(values in \$mm)

	LTM	FY2015E	FY2016E
Revenue	\$37.9	\$46.9	\$59.5
% Growth		290.8%	26.9%
EPS	0.05	0.14	0.22
% Growth		366.7%	57.1%
P/E	53.22x	19.94x	12.81x
EV/EBITDA	15.18x	9.73x	7.82x
EV/Sales	6.09x	4.91x	3.87x

## Market Performance



Benchmark: 100 % iShares U.S. Healthcare ETF (IYH).

## Investment Thesis

- 1. Robust Business Model – Emerging Consolidator of Services to Gastroenterologists:** *Prior to 2014, CRH Medical was solely in the business of selling medical devices to treat hemorrhoids, now a market with a potential \$500M in annual revenue. It has however recently expanded its presence into the much larger, more quickly growing and higher margin anesthesia market*
  - Good relationships in the ambulatory service center (ASC) segment increase CRH’s ability to continually grow through acquisitions
  - Announced four sizable acquisitions in 2015
- 2. Safe Space – Industry has Limited Economic Sensitivity:** *Not only is CRH catering to the needs of a quickly growing aging population, the necessity of the treatments it provides explains the low correlation between the company’s performance and macroeconomic trends*
- 3. Increasing Financial Flexibility and Attractive Valuation:** *CRH’s changing product mix leads to increased margins, and its no-dividend policy increases the rate at which the company is investing.*

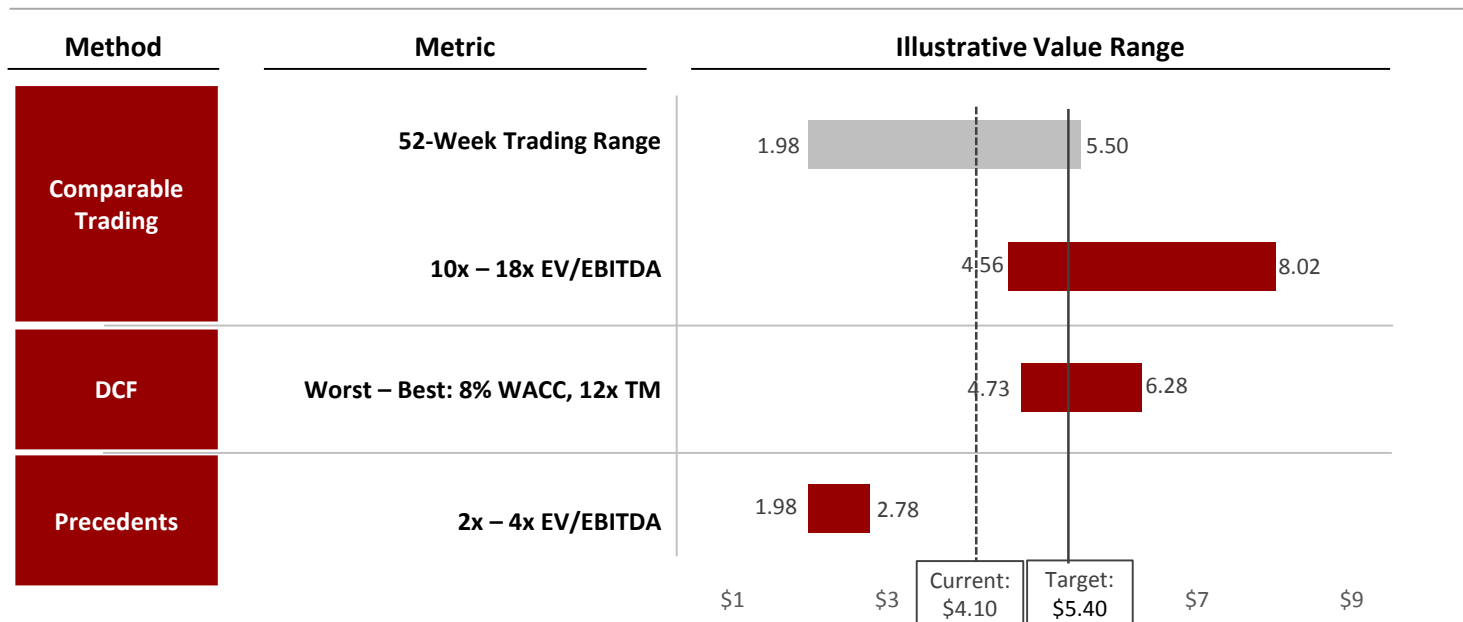
## Analysis of Performance

In November of 2015, CRH celebrated its one-year anniversary of its entrance into the anesthesia business, one that has proved to be enormously profitable and transformative for the company. Since its entrance, CRH has experienced revenue growth of over 530%.

The driving force behind our investment theses was CRH Medical’s unique ability to leverage the relationships it has developed with nearly 2000 GI’s across the US via the CRH O’Regan system in order to grow its anesthesiology services segment. This strategic advantage has materialized through the announcement of four acquisitions in the anesthesiology space, to which the stock has reacted positively. At the beginning of the year, CRH was performing roughly 48,000 procedures in this segment on an annualized basis. This has grown to 100,000 at year end.

DCM holds the belief that CRH’s existing relationships will continue to facilitate the company’s expansion via acquisitions. As CRH transitioned into the services business, it has experienced increased margins (EBITDA margin increased 305% between 2014 and 2015) and consistent positive cash flow (CAGR 162%). The company’s strong financial position ensures that its acquisition outlook for 2016 is positive.

## Valuation Summary





# Lannett Company, Inc. (NYSE: LCI)

## Company Overview

- Lannett is a top 25 generic pharmaceuticals company that develops, manufactures and distributes generic versions of branded pharmaceutical products in the US exclusively
- The company entered the Specialty Pharma space in 2015 as it expanded its branded product efforts
- The company has development and supply agreements with various partners including Azad Pharma AG and HEC Pharm Group
- It is primed for continued fast growth through commercialization of drugs in pipeline, development of products with market barriers to entry, and acquisition of complementary products that enhance internal efforts

## Position Snapshot

Average Cost	\$61.17
# of Shares	500
Value Invested	\$30,585
Portfolio Weight	[1.0%]
2015 HPR	-35.78%
HP Benchmark Return	-0.57%
Excess Return	-35.21%

All figures in USD

## Financial Summary

### Public Market Overview

(values in \$mm, as of Dec. 31, 2015, except for Share Price)

Share Price	\$40.12
Shares Outstanding (mm)	36.5
<b>Market Cap.</b>	<b>\$1,464.4</b>
+ Total Debt	\$1.0
+ Minority Interest	\$0.4
+ Preferred Equity	-
- Cash	\$222.7
<b>Enterprise Value</b>	<b>\$1,243.1</b>

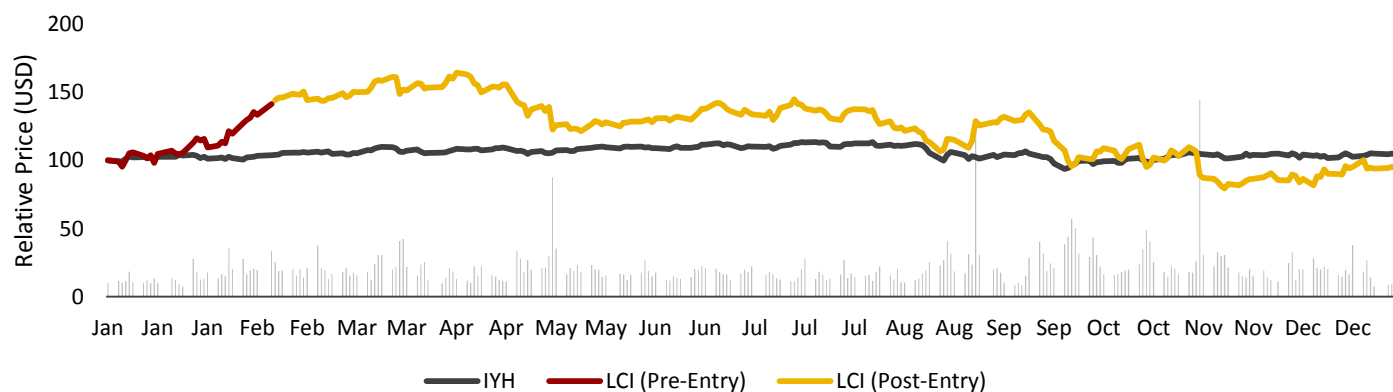
Beta	1.47
Dividend Yield	--
ROC	35.5%
52-Week High	\$72.44
52-Week Low	\$33.13

### Financials & Multiples

(values in \$mm)

	LTM	FY2015	FY2016E
Revenue	\$419.9	\$406.8	\$609.2
% Growth		48.6%	49.8%
EPS	4.11	4.45	4.09
% Growth		[179.9%]	-8.1%
P/E	8.75x	13.34x	8.80x
EV/EBITDA	4.77x	8.37x	4.02x
EV/Sales	2.60x	4.78x	1.79x

## Market Performance



Benchmark: 100 % iShares U.S Healthcare ETF (IYH).

# Lannett Company, Inc. (NYSE: LCI)

## Investment Thesis

- Diversifying Revenues:** Lannett's increasing revenue diversification enables the company to insulate itself against FDA and industry risks
  - LCI's acquisition of Kremers Urban, which closed at the end of November, will substantially diversify the revenue base, bringing additional specialty products into the revenue mix
- Reeling in R&D:** Lannett conducts in-house research as well as purchases Abbreviated New Drug Applications (ANDAs) to reduce R&D intensity, resulting in optionality value
  - LCI has acquired two additional ANDAs in 2015: Estradiol Tablets and Selegiline Hydrochloride
- Growth strategy:** Vertical integration allows Lannett to control costs; volume growth reduces dependence on price increases to improve their top line
  - Lannett's growth strategy is twofold. Firstly, their vertical integration in key growth segments allows Lannett to control costs and boost margins against peers. Secondly, their focus on increasing market share enables them to grow their top line by increased volumes as opposed to price increases. This is further discussed in the analysis of performance below.

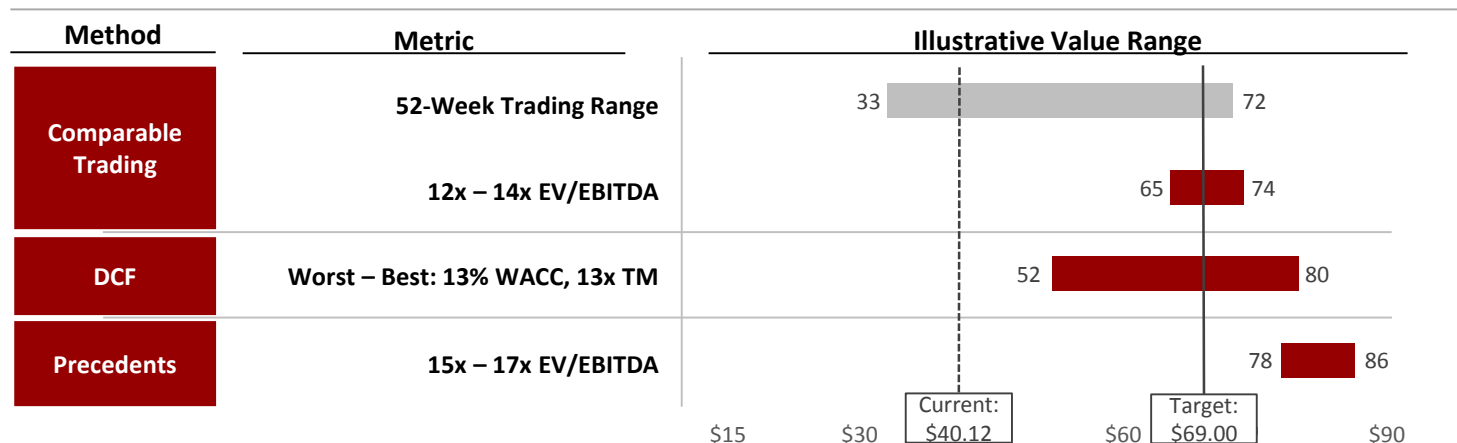
## Analysis of Performance

Lannett Company's stock has had a rough go throughout 2015, revisiting market sentiment similar to that of October 2014, when Bernie Sanders announced a congressional investigation on the "skyrocketing" prices for generic drugs. Political pricing concerns, most easily traced back to Clinton's September 21<sup>st</sup> comment, has resulted in drastic volatility as well as negative pricing pressure. Lannett has received a lot of media attention over the price increases of a few of its drugs, particularly digoxin. As pricing concerns were voiced in 2015, Lannett took a substantial hit, as did many of its competitors. However, further analysis indicates that, unlike the media would depict, Lannett has not been dependent on price increases for revenue growth. Although a few of their drugs have seen substantial price appreciation, these drugs account for a relatively small portion of their sales. Further analysis indicates that over the past quarter, Lannett has actually experienced an average *increase* in sales volume of 31.96% and a *decrease* in sales

	Sales Volume Change	Sales Price Change
Antibiotic	9%	0%
Cardiovascular	-34%	-22%
Gallstone	55%	14%
Glaucoma	28%	18%
Gout	-97%	0%
Migraine	3%	-8%
Muscle Relaxant	415%	-26%
Obesity	-1%	8%
Pain Management	0%	23%
Thyroid Deficiency	49%	-26%
<b>Weighted Average</b>	<b>31.96%</b>	<b>-9.05%</b>

prices of 9.05% on a weighted-adjusted basis. Despite the recent 40% decline in its stock price, Lannett still looks like a great long-term story, as it continues to grow its revenue and net income through strategic decisions including vertical integration, and its focus on the opioid based API segment. DCM believes that LCI is a baby thrown out with the bathwater. Indeed, in contrast with other pharma companies, its revenue growth is explained by increases in sales volume rather than price changes, and thus pricing concerns do not put its growth outlook at risk. As such, we remain confident that the stock will recover.

## Valuation Summary



# Celgene (Nasdaq: CELG)

## Company Overview

- Celgene Corp is a global biotechnology company focused on the discovery, development and commercialization of drugs for the treatment of cancer, immune and inflammatory diseases
- The company attributes its competitive advantage to the relative speed with which they develop and market new and innovative products
- Celgene has just over 6,000 employees globally and is headquartered in Summit, NJ
- The company has ten commercialized products and five additional products in clinical stages. It also has collaborative agreements with several companies including Novartis Pharma AG, Acceleron Pharma and Agios Pharmaceuticals

## Position Snapshot

Average Cost	\$108.85
# of Shares	400
Value Invested	\$43,540
Portfolio Weight	[2.1%]
2015 HPR	11.36%
HP Benchmark Return	-1.78%
Excess Return	13.14%

All figures in USD

## Financial Summary

### Public Market Overview

(values in \$mm, as of Dec. 31, 2015, except for Share Price)

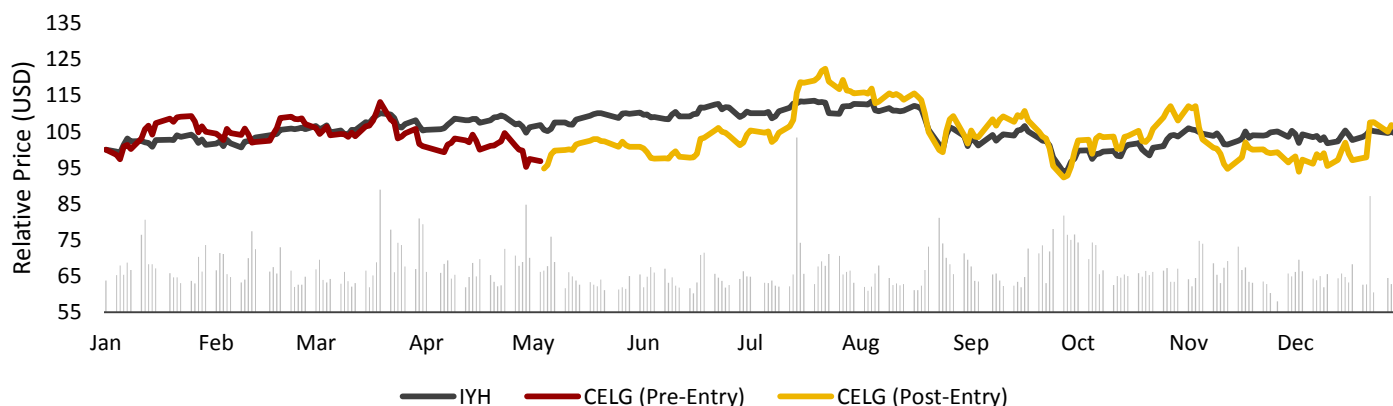
Share Price	\$119.76
Shares Outstanding (mm)	785.7
<b>Market Cap.</b>	<b>\$94,095.4</b>
+ Total Debt	\$15,497.6
+ Minority Interest	-
+ Preferred Equity	-
- Cash	\$7,529.2
<b>Enterprise Value</b>	<b>\$102,063.8</b>
Beta	1.55
Dividend Yield	--
ROC	11.1%
52-Week High	\$140.72
52-Week Low	\$92.98

### Financials & Multiples

(values in \$mm, as of Dec 31, 2015)

	LTM	FY2015E	FY2016E
Revenue	\$8,778.2	\$9,233.1	\$11,116.3
% Growth		20.37%	20.40%
EPS	2.28	4.80	5.66
% Growth		88.24%	17.92%
P/E	47.87x	22.70x	19.25x
EV/EBITDA	37.70x	28.03x	19.96x
EV/Sales	10.66x	10.14x	8.42x

## Market Performance



Benchmark: 100 % iShares U.S. Healthcare ETF (IYH).

# Celgene (Nasdaq: CELG)

## Investment Thesis

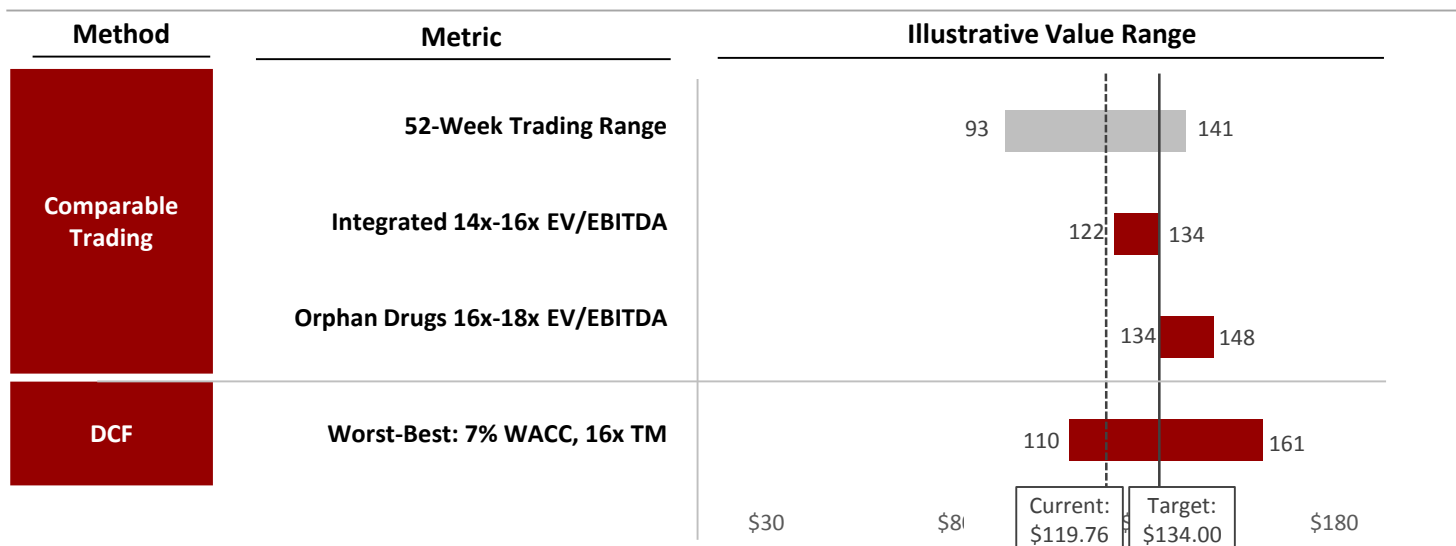
- Market Leader in Orphan Drugs:** *Celgene is the world's #1 orphan drug producer, leading with its multiple myeloma treatment, Revlimid. Its continued strength in the space is reinforced by the growth of one of its newest orphan drugs, Otezla*
  - Otezla is expected to reach 33% of its revenue share by 2019 (up 27.1% from its current 5.9% share), vastly improving revenue segmentation
- Gross Margin Strength:** *Celgene has maintained gross margins above 95% for more than the past five quarters. Their strong margins relative to their core comparables group are sustainable because of their internal sales force model*
- External Positioning:** *Celgene is strategically positioned to withstand industry risks including regulatory risk and pricing pressure*
  - Larger players with sustainable business models and proven returns on capital are less exposed to investors' fear of a 'biotech bubble'. Recent industry-wide selloffs due to pricing pressure have impacted small-caps and larger competitors like Celgene alike, despite the proportionately smaller degree of risk faced by large-caps
  - Celgene's revenue diversification has beat analyst expectations consistently for the past several quarters, positioning Celgene exceptionally well amidst a highly volatile market

## Analysis of Performance

Since Celgene's addition to the fund, the stock has returned 11.36%, outperforming the benchmark by 13.14% over the period. That being said, Celgene has seen quite drastic swings in its share price over the course of 2015. One of the most notable sell-offs was in the fourth week of September, after Clinton's tweet on high drug prices hits the biotech sector hard. CELG experienced nearly a 13% decline over the seven days following the tweet. However, as indicated by the third point of the investment thesis, DCM held the belief that the magnitude of CELG's sell-off, comparable to the fall in the Nasdaq Biotechnology Index and several other smaller-cap companies, was unwarranted. Celgene, unlike many of its smaller peers, has derived its value via demonstrated consistently proven returns and increasingly diversified revenue mix. Our conviction in a recovery played out, with the stock returning to pre-tweet levels the following week.

While competition has minimized revenue growth for Celgene's Revlimid, Otezla has been a strong performer, with Q3 2015 revenues sitting at \$140 million. Continued decline in dependence on its biggest sellers and growth of the revenue mix will be key determinants of Celgene's performance in 2016.

## Valuation Summary



# Desautels Fixed Income Fund

2015 Performance Summary & Positioning

*By Peter Huo, Fixed Income Strategist*



## Performance and Positioning

### Fixed Income Fund Performance

The Desautels Fixed Income Fund returned 9.8% gross of fees in 2015 compared to 10.1% for our blended benchmark. This year continues to be a great year for the broad fixed income asset class, but quarter-on-quarter performance has been volatile as the market switches between risk-on and risk-off modes. Our underperformance of 28 bp was primarily due to our lower duration exposure throughout the year. This shorter duration, however, resulted in a lower standard deviation and our Sharpe ratio of 1.42 outpaced that of the benchmark (1.22).

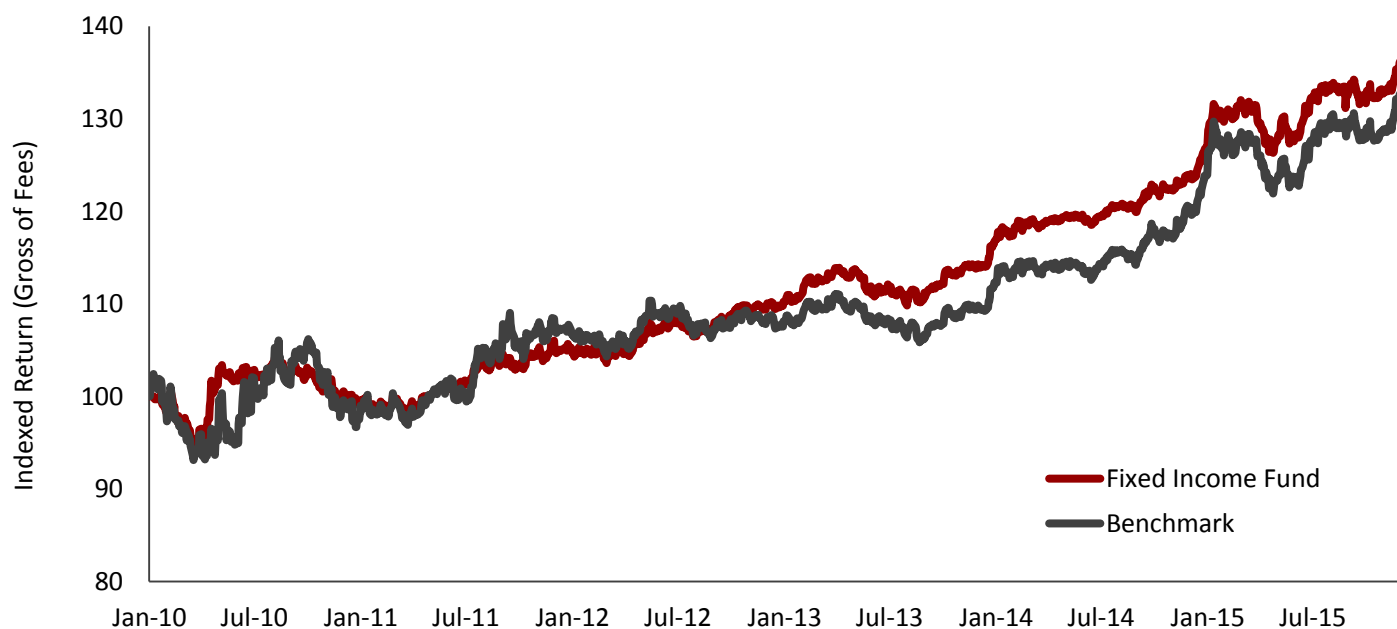
Since inception, our fund has produced annualized returns of 5.3%, versus 4.7% for the benchmark. Over this period, we have generated 1.7% of annual alpha on a risk adjusted basis. Below, we discuss current themes in the fixed income landscape, outline our views for 2016, and analyze some of our individual holdings.

### Fixed Income Fund Performance and Risk Metrics

Fixed Income Fund Returns				Performance Metrics				
Time Period	Gross Return	Net Return	Benchmark	Fixed Income Fund		Benchmark		
				2015	Inception	2015	Inception	
2015	9.8%	9.3%	10.1%	Annualized Return	9.8%	5.3%	10.1%	4.7%
Q1 2015	6.4%	6.3%	7.0%	Annualized Std Dev	5.2%	4.4%	6.3%	6.6%
Q2 2015	(1.8%)	(1.9%)	(3.0%)	Annualized Sharpe Ratio	1.42	0.64	1.22	0.35
Q3 2015	3.7%	3.6%	4.5%	Beta	0.78	0.55		
Q4 2015	1.4%	1.3%	1.4%	Annualized Alpha	1.5%	1.7%		
2 year*	9.7%	9.1%	10.2%	Tracking Error	0.35%	0.60%		
Since Inception*	5.3%	4.8%	4.7%					

\*Returns are annualized.

Performance metrics are calculated gross of fees.

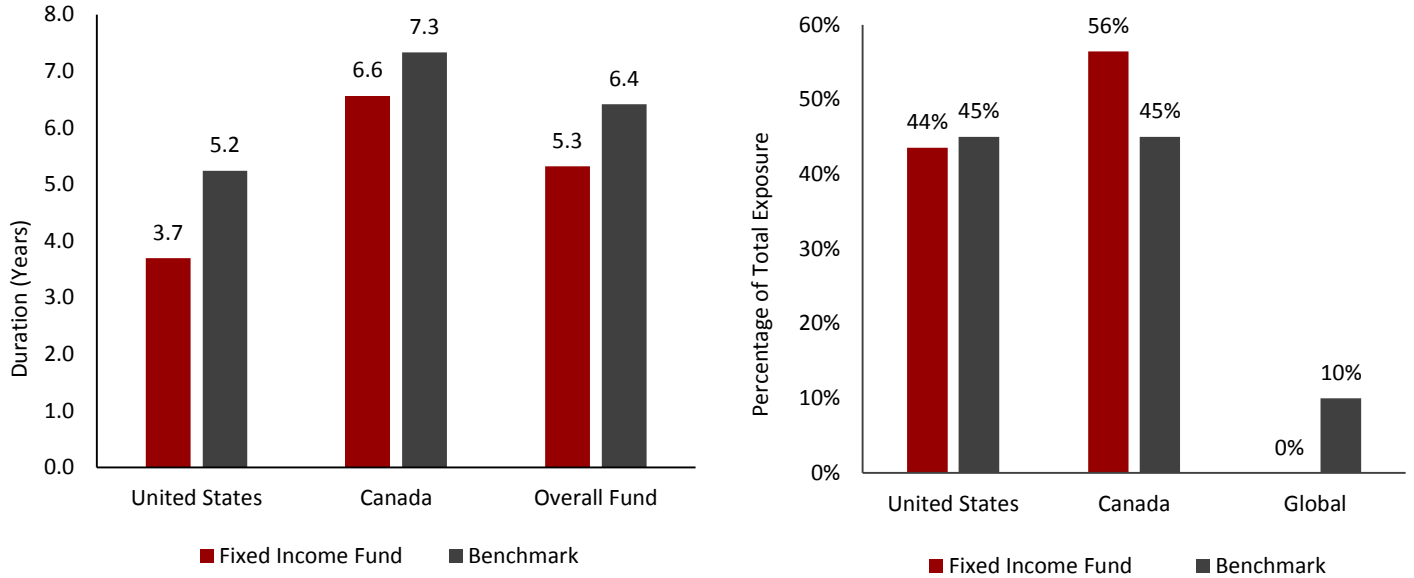


Benchmark is the Citi World Bond Index from inception to Feb. 8, 2011 and a 45% Barclays Aggregate Bond Index, 45% DEX Universe Bond Index, 10% Citi International Treasury Bond Index blended thereafter, measured in CAD. Fund inception date is January 20, 2010.

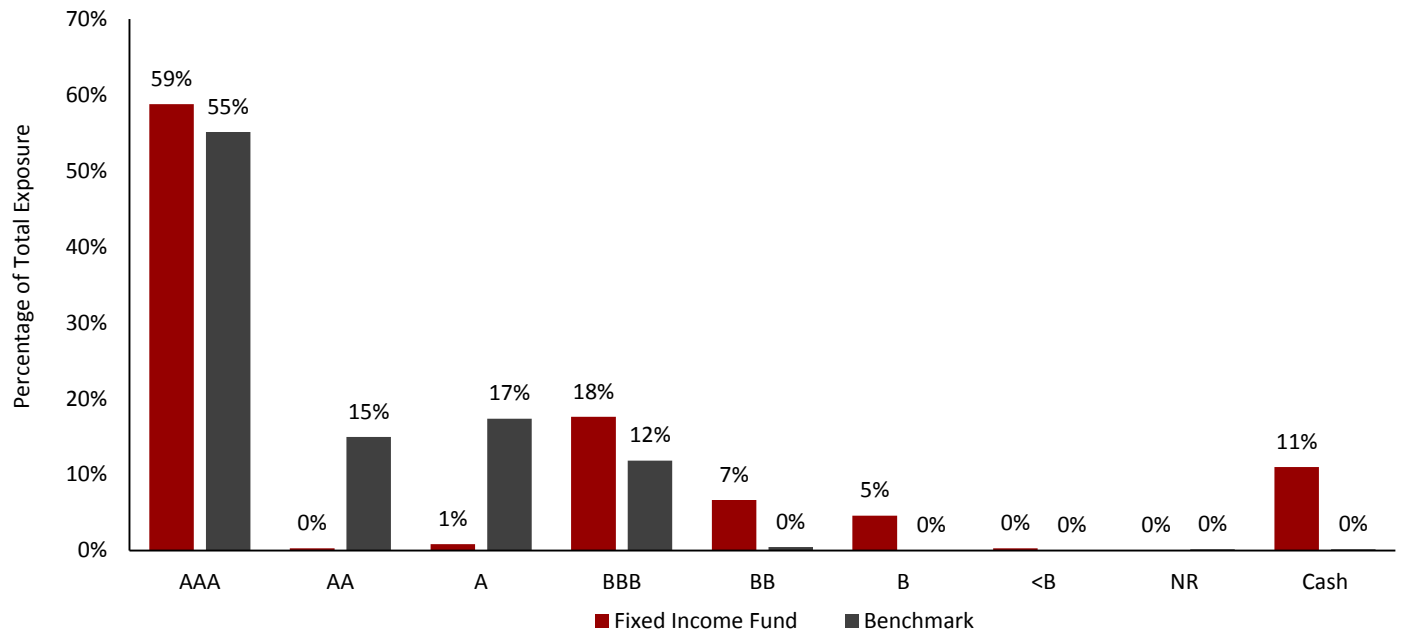
# Performance and Positioning

## Fixed Income Fund Duration, Currency, and Credit Ratings Exposure

### Duration and Currency Allocation



### Credit Rating Distribution



## Performance and Positioning

### Fixed Income Fund Holdings List

Fixed Income Fund Holdings					As of December 31, 2015	
#	Security Name	Units	Purchase Price	Market Price	Market Value	% of Total
1	iShares MBS ETF	550	106.74	149.61	82,283	16.4%
2	BMO Long Federal Bond Index	4,300	18.61	18.20	78,260	15.6%
3	iShares 3-7 Year Treasury Bond ETF	300	125.39	170.32	51,095	10.2%
4	Province of Alberta 2.55% 2022	400	99.54	104.05	41,619	8.3%
5	iShares Core U.S. Aggregate Bond ETF	270	143.28	150.04	40,510	8.1%
6	Home Trust 3.4% 2018	240	102.31	100.92	24,220	4.8%
7	Cogeco 4.925% 2022	220	109.41	109.72	24,137	4.8%
8	DirectCash Payments 8.125% 2019	190	102.75	100.50	19,095	3.8%
9	Bank of America 5.15% 2017	170	95.70	104.47	17,760	3.5%
10	Aimia 6.95% 2017	160	111.14	104.20	16,673	3.3%
11	Iron Mountain 6.125% 2021	150	102.99	101.79	15,269	3.0%
12	Canada Housing Trust 3.8% 2021	130	111.43	112.74	14,656	2.9%
13	Rona 5.4% 2016	140	103.75	101.94	14,271	2.8%
14	SPDR Barclays High Yield Bond ETF	200	39.40	47.10	9,421	1.9%
15	US Dollar	25,591	1.27	1.39	35,548	7.1%
16	Canadian Dollar	17,840	1.00	1.00	17,840	3.5%
<b>Value of Cash &amp; Securities</b>					<b>\$502,657</b>	<b>100.0%</b>
<i>Top 5 holdings</i>					\$293,767	58.4%
<i>Top 10 holdings</i>					\$395,652	78.7%

Note: All values in CAD.



# Desautels Fixed Income Fund

Fixed Income Markets Review and Outlook

*By Peter Huo, Fixed Income Strategist*



# 2015 Review and 2016 Outlook

## United States Macro and Duration

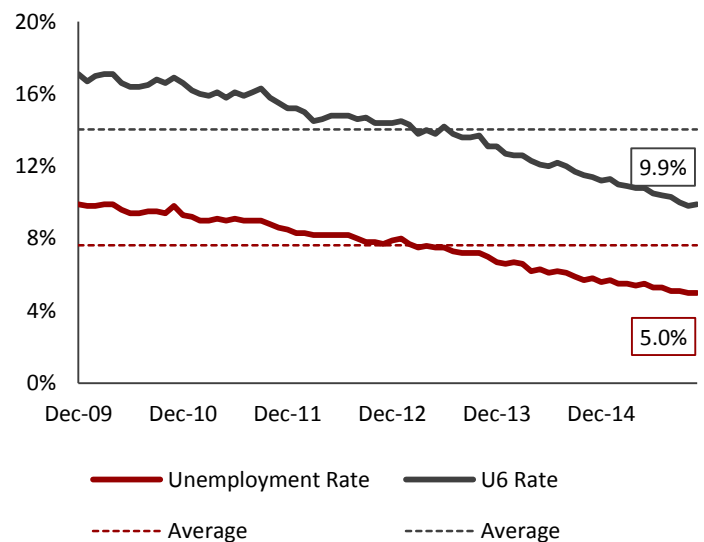
### US Economy: Above-Average Growth to Continue in 2016

No recovery lasts forever, but 2015 was another year of above-average growth for the US economy. From Q1 to Q3, real GDP growth hovered between 2.2% and 2.9%, well above the Street's December 2014 projection of 2.2% for 2015 and Fed's long-term target of 2.0%. With that being said, certain elements of weakness persisted, including poor wage growth and uncomfortably low inflation.

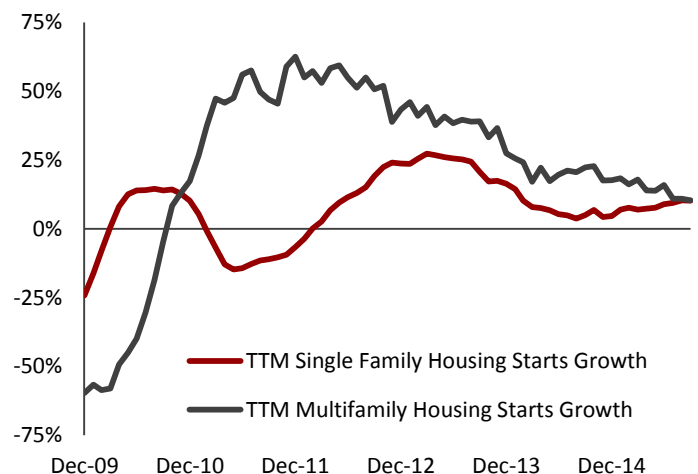
On the positive side, improvements in the labour market were particularly significant, with the unemployment rate reaching a post-crisis low of 5.0%. Even the U6 rate, which considers part-time workers unable to find jobs for economic reasons as unemployed, hit a post-crisis low of 9.9% (Figure 1). Furthermore, after several years of decline, the labour participation rate stabilized at 62.5%. Overall, we see labour market conditions improving further in 2016 and supporting private sector growth. However, as noted by Fed Chair Yellen, the US labour market is approaching Fed's goal of full employment. As such, the economy will require other catalysts to maintain above average growth beyond 2016.

At DCM, we see the housing sector supporting economic growth in the medium run. Some economists would certainly disagree with this view, based in part on the drop in the US homeownership rate, which in Q2 2015 fell to its lowest level since the 1960s. In our view, however, this phenomenon merely reflects the trend that households have been shifting from purchasing a house to renting or purchasing a condominium, as noted by the remarkable growth in multifamily housing starts since 2011. Meanwhile, single family housing starts remained robust (Figure 2).

**Figure 1: US Unemployment and U6 Rate**



**Figure 2: Housing Starts Growth by Type**

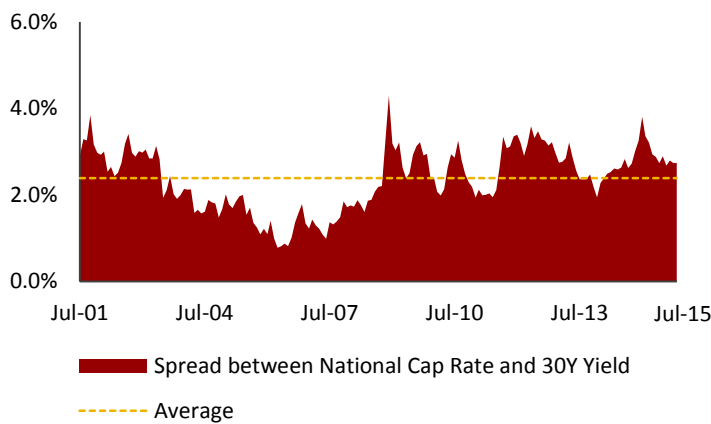


Source: US Bureau of Labor Statistics, Bloomberg.

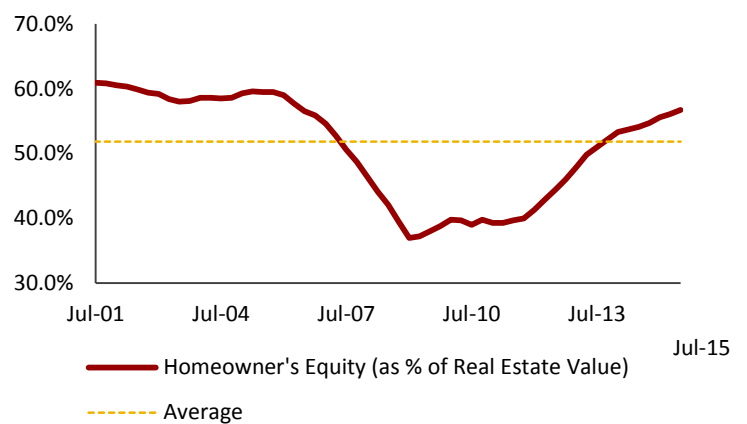
## 2015 Review and 2016 Outlook

Looking at the valuation of the American housing market and the health of household balance sheets, we believe that there is plenty of room for further real estate recovery in the US. From 2009 to Q3 2015, we have seen residential cap rates decrease from 7.0% to 5.7%, which we primarily attribute to the decline in long-term interest rates. Indeed, the spread between the US national cap rate and the 30Y treasury yield remains in-line with historical levels, excluding the bubble period from 2004-2007 (Figure 3). In terms of household leverage, homeowners' equity has recovered to pre-crisis levels and is positioned favourably to support continued advancement of the housing market (Figure 4).

**Figure 3: US Housing Valuation**

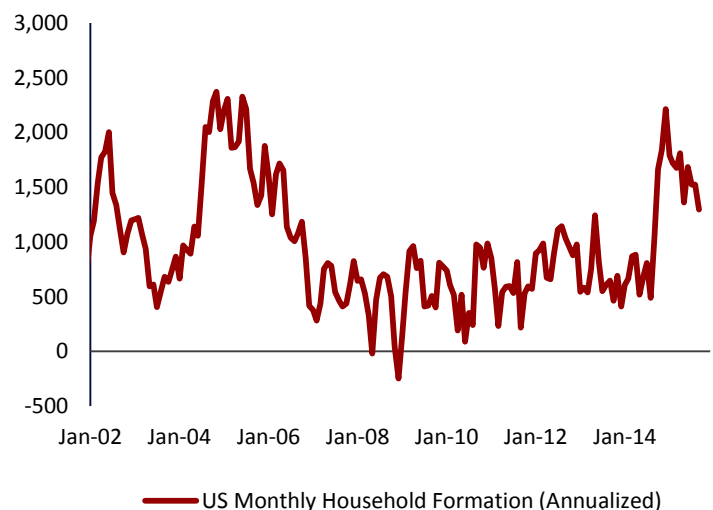


**Figure 4: US Household Leverage**



Our conviction in the US housing market is reinforced by impressive household development, which has averaged an annualized ~1.6 million new households since Q4 2014 (Figure 5). As residential vacancies remain near 20-year lows at 7.3%, new households looking for homes will provide a significant boost to housing starts over the coming years. This increase in demand, coupled with a labour market that is close to full-employment, is expected to put upward pressure on housing prices as well as inflation, as its effects flow through the economy.

**Figure 5: US Household Formations**



As the housing recovery accelerates, it is our view that it will help the US economy to continue its above-average growth trajectory in 2016.

Source: US Census Bureau, Bloomberg.

# 2015 Review and 2016 Outlook

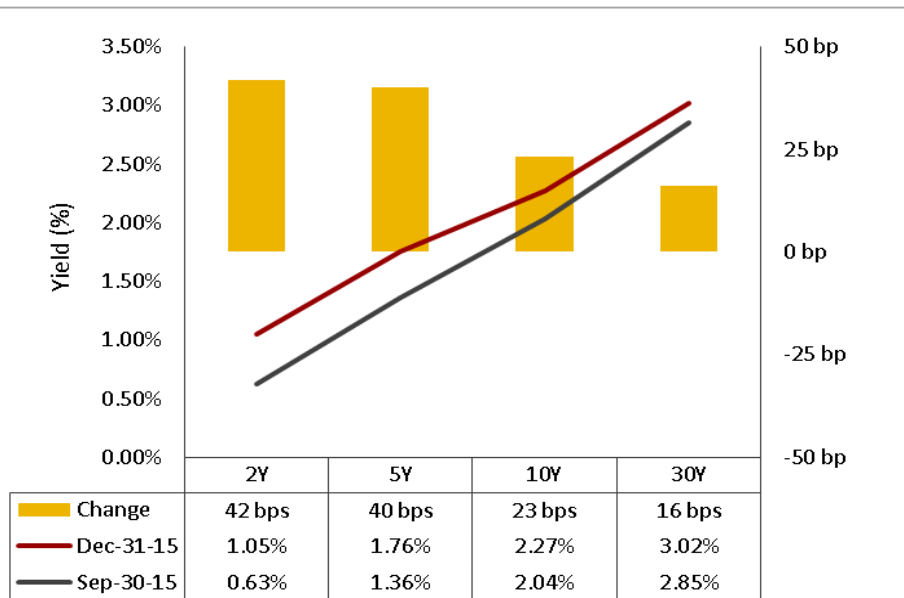
## US Rates: Short Duration Positioning in Anticipation of Rate Hikes

After close to 10 years of Zero Interest Rate Policy and continual pushbacks to liftoff expectations, the Fed finally decided to raise the Fed Fund target rate by 25 bp on December 16<sup>th</sup>, marking the beginning of a tightening cycle. As expected, the formal guidance emphasizes gradual increases over several years. The Fed ‘dot plot’ shows an expectation for four rate hikes in 2016 to 1.4%, the same as expected in September guidance. However, 2017’s Fed Fund Rate is projected to be 2.4% versus the previous forecast of 2.6%, while the long-run target remains at 3.5%.

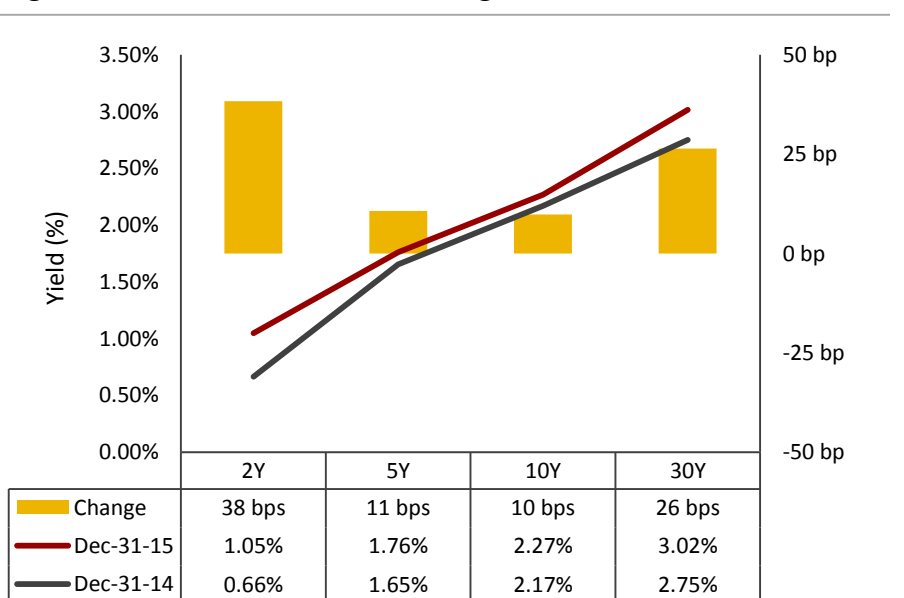
Looking at the shift of the yield curve we saw a modest bear flattening both YTD and in Q4 (Figure 6 and 7). While the 10Y yield increased by 10 bp YTD, it moved up 23 bp in Q4, largely due to the expectation of the coming rate hike. The 40 bp move of the 5Y yield in Q4 was noteworthy as well, as expectations of gradual tightening in the next few years become stronger.

Immediately after the rate hike announcement on December 16<sup>th</sup>, the 2Y and 10Y yield moved up by 4 bp and 7 bp respectively; on the day, they ended 2 bp and 4 bp higher. Compared to the 21 days during this volatile year where the 10Y yield moved by more than 10 bp, such a reaction is relatively mild. Considering the 80% probability of rate hike priced in the futures market prior to the announcement, this tamed reaction is no surprise.

**Figure 6: US Yield Curve – Q4 Changes**



**Figure 7: US Yield Curve – YTD Changes**



Source: Bloomberg.

## 2015 Review and 2016 Outlook

So what to think of US yields going into 2016? While major banks on the Street forecast the 10Y yield to be around 3% by the end of 2016, the market does not quite agree. Looking at the 1Y and 11Y yields on December 31<sup>st</sup>, we see that the market is expecting the one-year forward 10Y yield to be approximately 2.47%, merely 20 bp above the spot 10Y yield (Figure 8).

**Figure 8: Spot and Forward Yield**

As of December 31 <sup>st</sup> , 2016	
Spot 1Y Yield	0.78%
Spot 10Y Yield	2.27%
Spot 11Y Yield	2.32%
<b>Implied 1Y Forward 10Y Yield</b>	<b>2.47%</b>

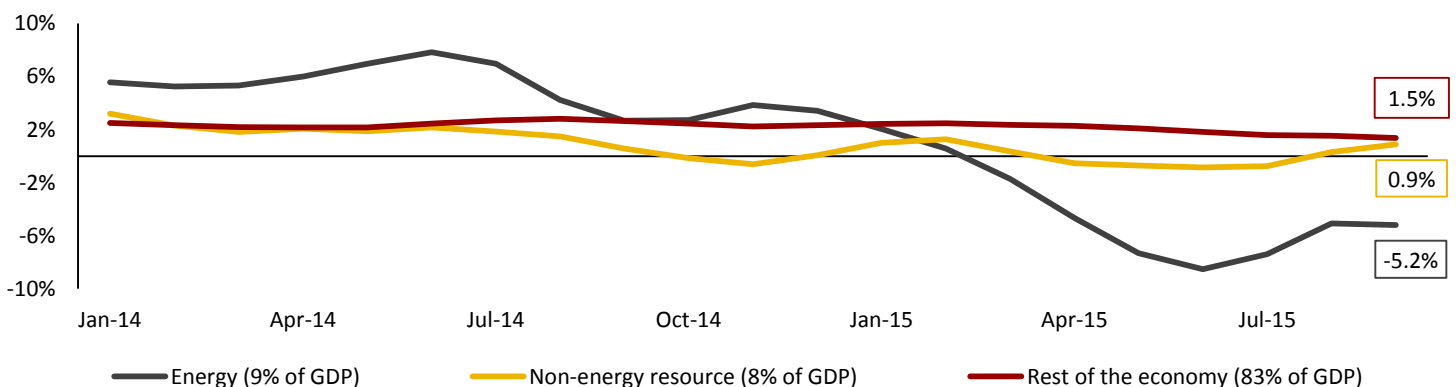
While we are not as bearish on rates as the banks are, we have reason to be slightly more bearish than the market. On one hand, we see the four forecasted rate hikes setting the tone for 2016. On the other hand, we see the real driver of yields to be any divergence from the four forecasted hikes, which heavily depend on the performance of the US economy. We believe that housing market strength can carry robust growth in 2016, from a risk reward point of view, and as a result, we do not feel the extra carry that can be earned by extending our duration would justify the additional risk. For this reason, we are maintaining a duration gap of 1.5 years for our US holdings.

### Canada Macro and Duration

#### Canadian Economy: Uncertain Environment with a Silver Lining in the Non-Resource Economy

2015 has been a year of uncertainty for the Canadian economy – oil prices touching historical lows, technical recessions in the first half of year, and a tight federal election race that resulted in a Liberal government. In contrast to the above-average growth rate and a strengthening labour market in the US, Canada’s real GDP growth has decelerated to 0% and the unemployment rate is back to over 7%. Inflation figures are healthy compared to south of the border, but they remain well below BoC’s 2% inflation target despite a 17% depreciation of the Canadian dollar in 2015. Many analysts on the Street believe that there will be very small room for improvement in 2016 as the low oil price will continue to weigh on growth. However, at DCM, we still see a silver lining in the Canadian non-resource economy.

**Figure 9: Resource vs. Non-Resource Economy**



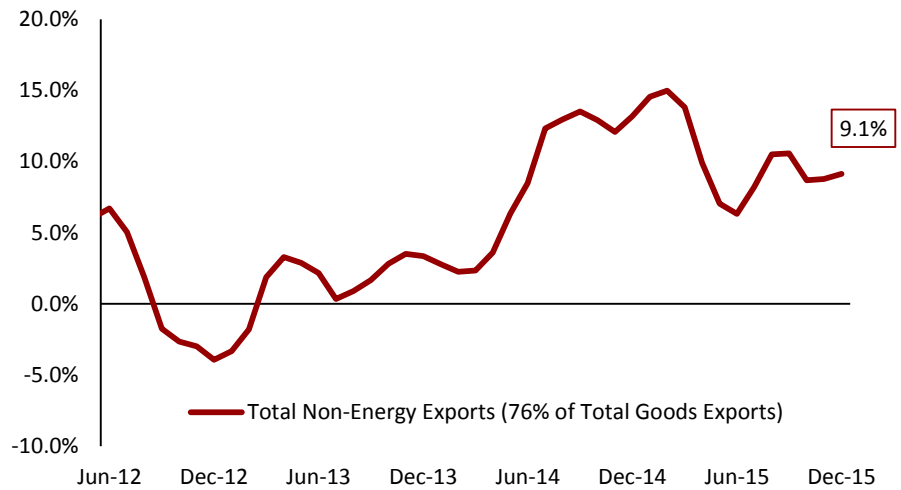
Source: Bank of Canada, Bloomberg.

## 2015 Review and 2016 Outlook

In fact, 83% of the Canadian economy is composed of non-resource industries, and the non-resource economy has been steadily growing at a rate of 2% since the credit crisis of 2008 (Figure 9 on the previous page). Although this growth rate has declined to 1.5% in Q3 2015, it was largely due to the overall income effect from lower oil prices. People are becoming more convinced that oil will stay persistently lower, and are adjusting their expenditures accordingly ahead of difficult times.

In our view, this income effect can reverse as non-energy export growth resumes and offsets the oil income loss. This export growth has picked up promisingly following the July rate cut (Figure 10), primarily bolstered by a lower Canadian dollar and stronger US demand, factors that we believe will persist going forward. Hence, we see non-energy exports to continue their growth trajectory throughout 2016.

**Figure 10. Pick Up in Non-Energy Exports in H2 2015**



In summary, while we acknowledge the downside risk of persistently lower oil prices on the Canadian economy, we still agree with BoC's expectation that Canada will reach full capacity by mid-2017.

### Canada Rates: Limited Downside for Canadian Yields

In 2015, policy makers in Ottawa have played a dominant role in the Canadian treasury market, with the BoC delivering a surprise 25 bp rate cut in January and a widely expected 25 bp cut in July (Figure 11).

The January cut was out of fears of an outsized negative impact from falling oil prices – a fear ultimately proven justified, while the July cut was prompted by BoC's concern over the decelerating real GDP growth that resulted in a technical depression in the first half of 2015. On the fiscal front, the election of a majority Liberal government with aggressive fiscal plans, including multi-billion-dollar infrastructure investments, has slightly weighed on treasury prices.

**Figure 11. A Tale of Two Rate Cuts**

*Market's Pricing on Jan 2*

**Probability of Rate Cut**

Jan 2015      0%

*Market's Pricing on Jul 3*

**Probability of Rate Cut**

Jul 2015      40%

Source: Bank of Canada, Bloomberg.

## 2015 Review and 2016 Outlook

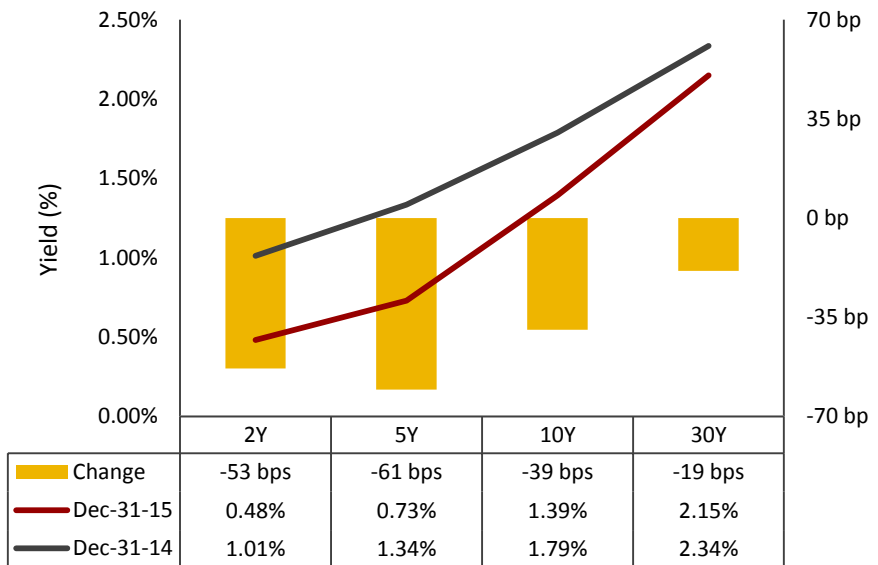
In contrast to the bear flattening seen in the US market, the Canadian yield curve underwent a modest bull steepening YTD, as the front end of the curve was driven down by the two rate cuts (Figure 12). For the 10Y yield, we saw a drop of ~40 bp YTD as concerns over the economy became more pronounced throughout the year with persisting low oil prices and weak exports.

Some market commentators speculate that Canadian yields will continue to be dominated by BoC actions in 2016, namely by another potential rate cut. Indeed, as of December 31<sup>st</sup>, the interest rate futures market is actually pricing over 33% probability of another rate cut by July 2016 (Figure 13).

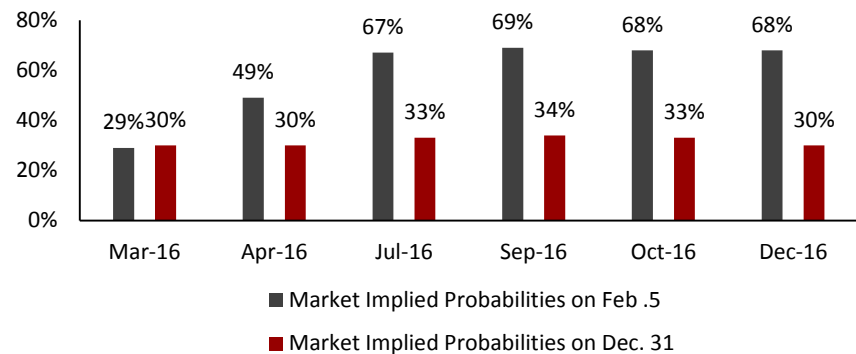
At DCM, we consider another cut to be unwarranted for four reasons. First, doing so leaves the BoC less room to maneuver as it gets closer to the zero interest rate bound. Second, the BoC should be wary of the inflationary pressure of another cut as core inflation remains steady around 1.9%. Third, expansionary government spending and tax reforms from the Trudeau government is a viable alternative to stimulate the economy in an already low interest rate environment. Lastly, as discussed in the previous section, we are convinced in the ability of the non-resource economy, in particular non-commodities exports, to deliver economic growth in 2016.

Therefore, we see limited further downside to Canadian yields in 2016. As we are slightly more bullish on the Canadian economy than the market is, we currently maintain a duration gap of 0.7 years relative to our Canadian benchmark.

**Figure 12. Canadian Yield Curve – YTD Changes**



**Figure 13. Market's Pricing of Rate Cut Probability**



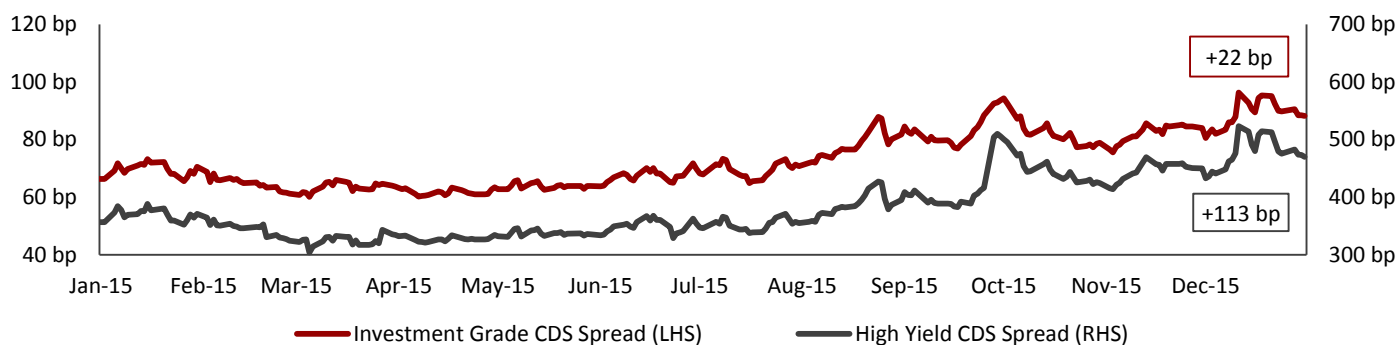
Source: Bloomberg.

## Credit

### US Credit : Deteriorating Fundamentals due to Share Buybacks and M&A

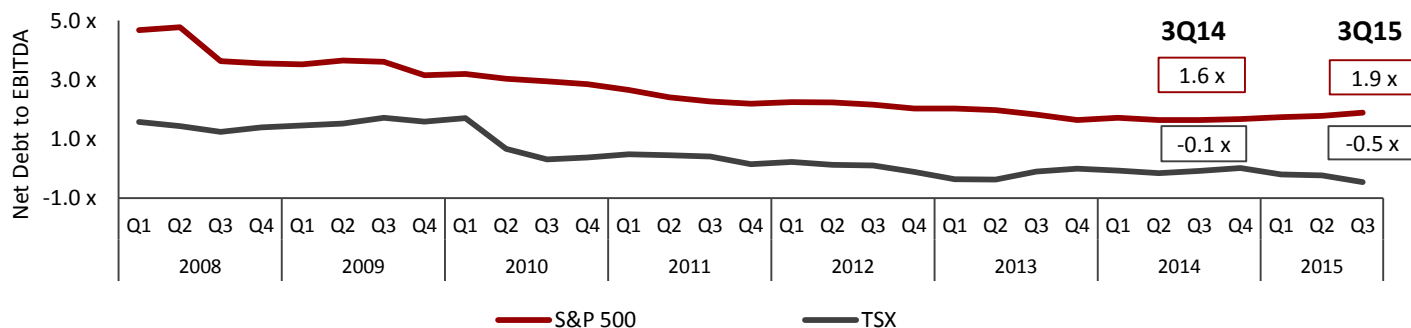
After over 2 years of a credit-friendly environment with continued corporate deleveraging and restrained macro risks supporting spread compression, H2 2015 saw major spread widening. This reversal was driven by macro volatility, including China’s devaluation of the Yuan, in addition to major idiosyncratic risks such as Glencore and VW. In particular, subdued oil prices drove the spread spike in the high yield space during Q4. For the year, the 5Y IG and HY CDS indices widened by 22 and 113 bp respectively (Figure 14).

**Figure 14. North-American CDS Indices Widening**



From a fundamental perspective, Corporate America’s credit profile has significantly worsened in the last year due to the emerging theme of corporate re-leveraging. Since the credit crisis in 2008, North American firms had undergone an impressive deleveraging cycle (Figure 15), which plateaued in the past year. Compared to a year ago, the average Net Debt / EBITDA of S&P 500 companies has increased from 1.6x in Q3 2014 to 1.9x in Q4 2015.

**Figure 15. Net Debt / EBITDA of S&P 500 and TSX Companies**



As 2015 continues to be a record year for US corporate bond issuance, a natural question arises: where do the proceeds go? Unfortunately, they are being used for credit-unfriendly purposes such as funding dividends and share buybacks as well as an unprecedented volume of M&A activity.

Source: Bloomberg.



## 2015 Review and 2016 Outlook

In 2015, M&A volume in the US increased 30% YoY to reach \$2.8 trillion. Mega deals of over \$10 Bn were of common occurrences (Figure 16), and the jaw-dropping pending merger of Pfizer and Allergan valued at \$184 Bn stands to be the second largest M&A transaction in corporate history. In 2016, we expect the American M&A market to continue its strong path amid an environment of cheap debt and low organic growth.

Coupled with a coming increase in share buybacks and dividend programs, we see the fundamentals of US credit conditions to keep deteriorating in 2016. With that said, we will keep an eye on specific names and source credit ideas focused on bottom-up research and analysis.

### Canadian Credit : Cheapening Despite Improving Fundamentals

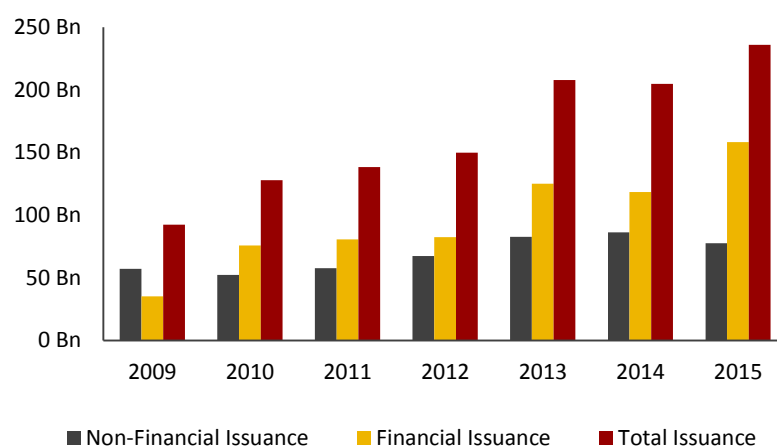
As Figure 15 from the previous page shows, the Canadian post-crisis de-leveraging cycle has been less pronounced than that of the US. But unlike the US, Canada is continuing its de-leveraging. The average Net Debt / EBITDA of TSX constituents has improved from -0.1x in Q3 2014 to -0.5x Q3 2015. In addition, contrary to the booming American M&A market, volume in the Canadian M&A market was down 38% in 2015. The obvious drag came from the energy industry –how can firms properly price and acquire an energy asset when its NAV changes by 20% every two weeks?

Although continued de-leveraging and subdued M&A activities have been credit-positive, heavy primary issuance during the year has largely weighed on spreads (Figure 17). Therefore, the cheapening of Canadian credit despite improving fundamentals represents an interesting opportunity for us to add specific names to our portfolio. We reckon that macro risks will continue to weigh on spreads, but we will focus on fundamental research to identify investments with a comfortable margin of safety.

**Figure 16. US M&A Count by Value**

Deal Size Over...	2014	2015
\$50 Bn	8	7
\$40 Bn	11	12
\$20 Bn	20	23
\$10 Bn	37	63
\$5 Bn	86	118
\$1 Bn	395	445

**Figure 17. Canadian Corporate Debt Issuance**



Source: Bank of Canada, Bloomberg.

## 2015 Review and 2016 Outlook

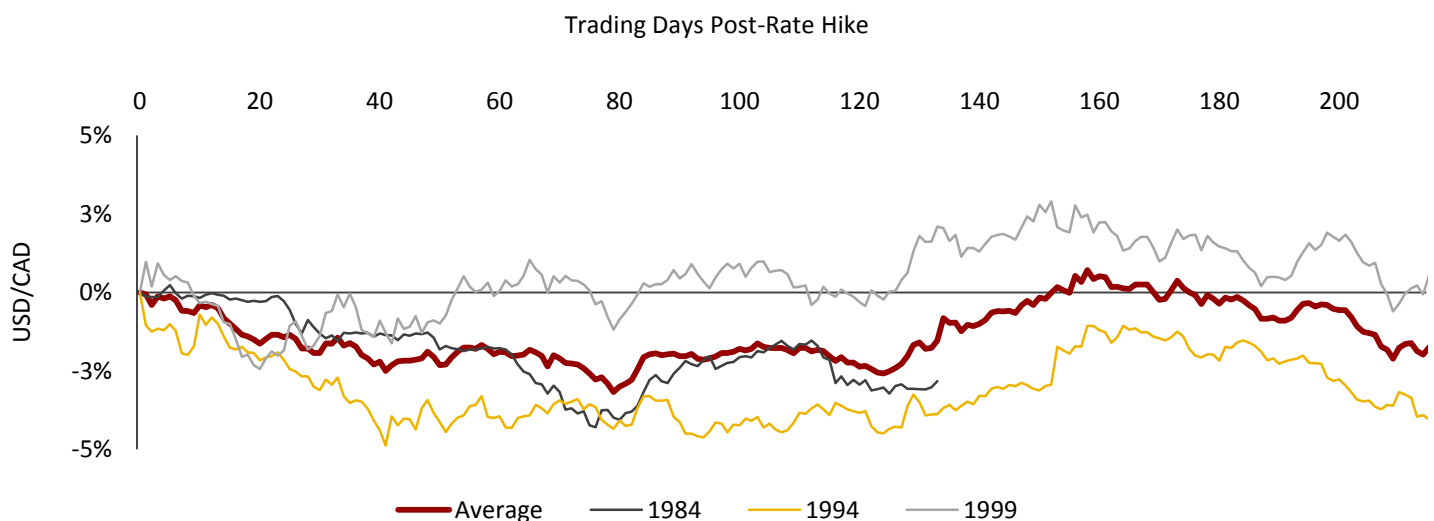
### Currency

In 2015, CAD has depreciated by another 17% against USD, after a 10% depreciation in 2014. The diverging monetary policy between the two countries in addition to subdued oil prices were the main drivers for this depreciation. However, DCM believes that there will be limited further downside for CAD in 2016.

Although oil recovery is expected to be volatile, it should nevertheless provide minimal upward pressure to CAD in 2016. To analyze the impact of diverging monetary policy, we have looked at the reaction of USD/CAD to Fed tightening cycles in 1984, 1994 and 1999. Out of the six tightening cycles since the 1980s, these three cycles are most comparable to the current one because the market was widely expecting them as well.

As seen in Figure 18, the reactions of CAD to Fed rate hikes have been less than 2% historically, with most of the downside occurring within the first three months following the initial hike. This should be no surprise as these tightening cycles were widely expected and the market was already pricing most, if not all, of the impact. For the current cycle, the pace of tightening will only be gradual, and we believe that as a result, the first rate hike should capture most of the upside for USD. Indeed, on the day following the lift-off on December 16<sup>th</sup>, the CAD was down 1.3%. Hence, in the near to medium term, we expect any further downside to CAD to be very narrow. For this reason, we do not have significant under or overexposure to either CAD or USD.

**Figure 18. USD/CAD and Fed Historical Tightening Cycles**



Source: Bloomberg.

# Desautels Fixed Income Fund

## Holdings Review

*By Anish Shah, Jonathan Kamel, Adam Marcovitz, Michael Fishman & Archer Shen*



# DirectCash Payments 8.125% 2019

## Company Overview

- DirectCash Payments (DCI) is a \$200mm market cap consumer finance company operating a network of ~21,000 ATMs and selling ATM terminals in addition to long-term processing contracts
- Market leader in Canada and Australasia, and third largest in the UK
- Grew aggressively in the last 2-3 years through four acquisitions in all three geographic regions
- Non-ATM Services include providing access to payment networks, selling and processing prepaid debit and credit cards, and selling of debit terminals

## Catalysts

- DCI continues to make small asset purchases in its core markets at bargain prices (~2x EV/EBITDA) and achieves economies of scale
- Tuck-in acquisition of Ezeatm Services in 2014 in an undeveloped Australian market has yet to fully play out as integration of ATMs with existing infrastructure is still underway

## Risks

- Diminishing use of cash and entrance of new payment technologies may continue to render ATMs obsolete in the near future and this could harm DCI's ATM business
- Pending ruling by the Parliament of England on the ban of surcharge fees on ATMs, which could impact margins on 7% of DCI's ATMs

## Financial Summary

### Bond Overview

(as of Dec. 31, 2015)

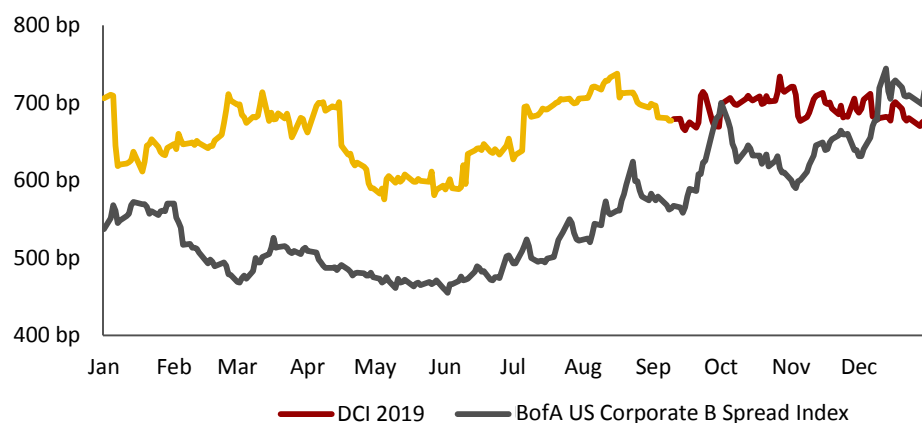
Price	100.00/102.00
Coupon	8.125%
YTM	7.48%
YTW	7.26%
G-Spread	677 bp
Modified Duration	2.18
Amount Outstanding	125mm
Rating (S&P)	B+

### Financials

(values in C\$m)

	LTM	2015E	2016E
<b>Revenue</b>	279.8	273.1	266.8
<i>% Growth</i>	1.0%	(2.4%)	(2.3%)
<b>Gross Profit</b>	131.6	134.2	132.7
<i>Margin</i>	47.0%	49.1%	49.7%
<b>EBITDA</b>	68.7	66.7	62.2
<i>% Growth</i>	(5.9%)	(2.9%)	(6.7%)
<b>Net Debt / EBITDA</b>	2.65x	2.60x	2.53x

## Bond G-Spread and Rating Category Performance



## Position Snapshot

Average Cost	\$102.75
# of Units	190
Value Invested	\$19,095
Portfolio Weight	3.80%
Position HPR	0.3%
Corp Index HPR*	0.7%
Excess Return	(0.4%)

All figures in CAD

\*Corp Index: 100% FTSE TMX Canada All Corporate Bond Index.

# DirectCash Payments 8.125% 2019

## Investment Thesis

- Cash flow stability across operating segments:** In all its geographic markets, DCI holds the highest market share in a fragmented industry with high barriers to entry, allowing it to maintain a stable EBITDA margin
  - DCI can thus continuously acquire ATM assets at low multiples (~2x EV/EBITDA) from smaller players and offset the industry-wide revenue decline of ~2%, achieving economies of scale with low integration risks thanks to DCI's serial acquisition expertise
  - Although acquisitions are funded with a combination of debt and cash, DCI has consistently paid down debt post-acquisition in order to limit its overall leverage
  - Recent expansion into the Credit Union and Financial Institutions transaction processing business represents further revenue diversification into another stable, high margin segment
- Dividend policy is not as alarming as it appears:** DCI's operations have consistently demonstrated a strong cash flow generation profile
  - While a generous dividend policy has weighed on the market's perception of DCI's credit profile, it is clear to us that management, who has an 18% stake in the company, is focused on solvency, as evidenced by a recent cut in the FFO payout ratio despite an increase in sales
- Debt repayment likely even under very conservative assumptions:** Assuming conservative operating assumptions as listed in the table below, our financial analysis indicates that there is a comfortable margin of safety for the 2019 bond to be repaid
  - Our Base Case assumptions imply a scenario where new acquisitions fail to offset the industry decline rate while margin deteriorates and dividend payout policy remains aggressive
  - Even under such a conservative scenario, EBITDA needs to drop by 19% in order to breach covenants on secured loans due in 2017, giving us comfort that these debts will be renewed

Assumptions	2013	2014	2015-19 Forecast (Base Case)
Sales Growth	25%	15%	-2%
SG&A / Sales	18%	16%	21%
EBITDA Growth	28%	9%	-1% to -7%
Capex / Sales	4%	5%	8%
Dividends per share	\$1.38	\$1.44	\$1.44 to \$1.62

## Analysis of Performance

Faced a maturing ATM industry in all its markets, DCI has pursued both margin expansion and revenue growth through acquisition strategies to keep EBITDA steady. In Q1 2015, margin was bolstered by DCI's diversification into the transaction processing business. Q2 brought revenue and transaction count growth across all segments owing to strategic, high-volume ATM contract acquisitions. In Q3, despite revenue growing 5% Y/Y, the FFO payout ratio continued to decline (from 52.2% Q314 to 48.5% Q315). This affirms management's focus on solvency rather than creating a short-term cash grab.

In 2015, DCI 2019's G-spread experienced both volatility and widening owing to general deterioration in high yield markets. Despite positive quarterly results, the spread on DCI 2019 widened by 80 bp from June through August, as the US High Yield B Spread Index widened by close to 200 bp in the same time period. On September 11<sup>th</sup>, we initiated our position at a G-spread of 672 bp as we felt the market was overlooking DCI's solid credit profile. Since our initiation, while the high yield market has seen further widening, the spread on DCI 2019 has remained stable and we expect further compression as our theses play out.

# Cogeco Cable 4.925% 2022

## Company Overview

- Quebec-headquartered cableco with 3 main business lines:
  - Cogeco Cable (Ontario & Quebec)
  - Atlantic Broadband (US)
  - Enterprise Data (North America & UK)
- Cable and Atlantic Broadband segments: Hybrid fibre-coaxial network, offering digital TV, HSI and telephone to business and residential clients
- Enterprise Data segment: Cloud, managed hosting, colocation and IT through datacenter network
- Network focused on underserved regions

## Catalysts

- Announcement of significant deleverage in near-future to restore target ratios post-acquisition
- Margin growth from successful shift in revenue mix to more cloud and server-based offerings
- Current CRTC proceedings resulting in legislation that more stringently regulates programming price structures

## Risks

- Continued cloud market concentration towards largest players affecting the Enterprise segment
- Accelerated increases in programming costs, particularly in US, where the content market is far less regulated
- Faster-than-anticipated secular decline in Pay TV as households switch to over-the-top content

## Financial Summary

### Bond Overview

(as of Dec. 31, 2015)

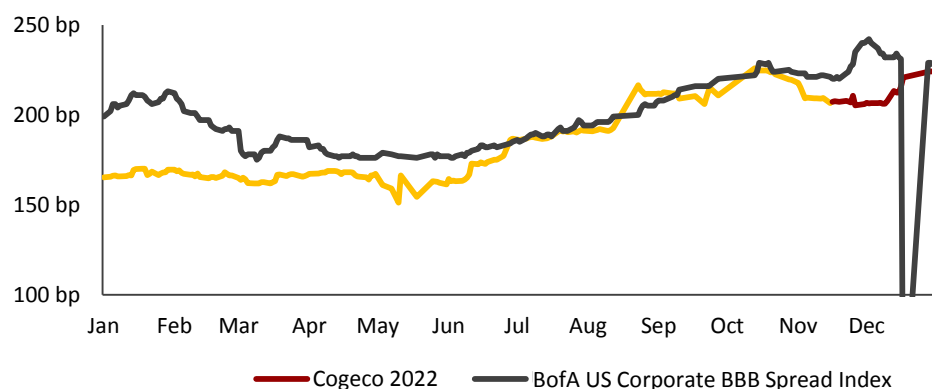
Price	109.42/110.00
Coupon	4.925%
YTM	3.12%
G-Spread	219 bp
Modified Duration	5.21
Amount Outstanding	200mm
Rating (S&P/DBRS)	BBB-/BBBL

### Financials

(values in C\$m)

	LTM	2015E	2016E
<b>Revenue</b>	2,043	2,104	2,203
% Growth	4.9%	3.0%	4.7%
<b>Gross Profit</b>	940	937	1,004
% Margin	46.0%	44.5%	45.6%
<b>EBITDA</b>	931	965	998
% Growth	4.2%	3.6%	3.5%
<b>Net Debt / EBITDA</b>	3.30x		

## Bond G-Spread and Rating Category Performance



## Position Snapshot

Average Cost	\$109.41
# of Units	220
Value Invested	\$24,137
Portfolio Weight	4.80%
Position HPR	0.9%
Corp Index HPR*	0.9%
Excess Return	0.0%

All figures in CAD

\*Corp Index: 100% FTSE TMX Canada All Corporate Bond Index.

# Cogeco Cable 4.925% 2022

## Investment Thesis

- Canadian Cableco Outlook Overlooks Competitive Advantage:** Fiber to the Home overlap in Cogeco's small-town networks is currently limited, and is unlikely to rapidly expand in the near term. This will effectively shield Cogeco from competing offerings in many of its key cable segments
  - Offering cheap high speed internet (HSI) in underserved regions coupled with Cogeco's bargain pricing model and top-end bandwidth options has proven successful in the SMB segment, expanding the service's addressable market
- Enterprise Data Unit Growth:** Consolidation in Cogeco's data centers will cut out redundancies and lead to shared operating and capital expenses resulting in: i) Large capex outlays in recent quarters to fall going forward ii) Data hosting capacity to significantly expand, helping revenue growth and result in a shift to higher-margin cloud-based offerings
- US Cable Presents Stable Revenue Source:** Atlantic Broadband focuses on rural markets mainly served by telcos resulting in Limited IPTV overlap in TiVo rollout
  - Atlantic Broadband is the first TiVo provider in all its markets and offers superior technologies than its main competitors that offer DSL copper and satellite products
- Cash Flows & Deleveraging:** We expect Cogeco to proceed with notable deleveraging in coming quarters following the MetroCast acquisition in June 2015
  - Management seems to be following an implicit target Net Debt/EBITDA ratio of 3.0x: the ratio rose to 3.4x following the Peer 1 and Atlantic Broadband acquisitions, and no further acquisitions were made until the ratio fell to 3.0x at the time of the MetroCast acquisition

## Analysis of Performance

We initiated the Cogeco 2022 position on November 17<sup>th</sup>, 2015 at a spread of 204 bp. Since then, Cogeco's G-spread has slightly widened to 219 bp due to the general credit market conditions. There was, however, a modest spread compression in Q4 2015, which we believe is due to some of the elements in our investment thesis beginning to materialize, particularly related to the growth in Enterprise Data Unit.

Earlier during the year, the credit market reacted positively to the consolidation of Cogeco Data and Peer 1 Hosting under Cogeco's Enterprise Data Services unit, which showed efficiency gains in May. This was shortly reversed by the CNOOC requesting the CRTC to investigate "surge pricing" rates charged in network wholesaling to independent ISP's. In June, Cogeco announced its debt-funded acquisition of MetroCast for US\$200mm. As mentioned in our thesis, we believe that Cogeco will focus on deleveraging in the medium term until it improves its credit profile.

## Valuation Summary

As of December 31, 2015	Market Cap (\$ Bn)	Operating Metrics			Financial Metrics			Bond Valuation	
		EBITDA / Sales	Avg. Network Speed	Sales Growth	Capex / Sales	Net Debt / EBITDA	EBIT / Int. Exp	S&P Rating	G-Spread
Shaw Communications (SJR 5.5% 2020)	\$12.4	43.4%	3.00 Mbps	4.7%	18.4%	2.3x	4.7x	BBB-	180
Manitoba Telecom (MBT 4.0% 2024)	\$2.3	34.6%	2.24 Mbps	(1.3%)	18.1%	2.0x	1.6x	BBB	231
Rogers Communications (RCI 4.0% 2022)	\$27.3	38.1%	1.67 Mbps	1.1%	17.5%	3.5x	3.8x	BBB+	195
Videotron (QBR 6.875% 2021)	\$3.8	36.1%	2.82 Mbps	1.9%	16.6%	4.5x	1.8x	BB	177
Bell (BCE 3% 2022)	\$49.9	39.6%	2.00 Mbps	3.1%	17.8%	4.4x	5.7x	BBB+	186
Telus (T 2.35% 2022)	\$26.6	35.8%	2.54 Mbps	5.2%	20.6%	2.7x	5.0x	BBB+	181
<b>Cableco Mean</b>	<b>\$20.4</b>	<b>37.9%</b>	<b>2.38 Mbps</b>	<b>2.5%</b>	<b>18.2%</b>	<b>3.2x</b>	<b>3.8x</b>	-	<b>192</b>
<b>Cogeco Cable (CCA 4.925% 2022)</b>	<b>\$3.3</b>	<b>45.7%</b>	<b>2.78 Mbps</b>	<b>15.1%</b>	<b>22.9%</b>	<b>3.1x</b>	<b>3.6x</b>	<b>BBB-</b>	<b>218</b>

# Home Capital Group 3.4% 2018

## Company Overview

- Home Capital Group (HCG) is a Canadian deposit-taking institution that provides mortgage and retail lending
- Focusing on providing fixed rate residential mortgages in the Alt-A market, HCG targets immigrants and self-employed individuals whose official credit scores don't reflect their actual credit worthiness
- Besides servicing its own loans, HCG has been acquiring mortgage service rights which generates a stable yearly revenue of 15 bp per \$1 of mortgage. In addition, HCG has been securitizing its insured mortgage portfolio off-balance sheet to create lending capacity for higher-margin Traditional (longer term) loans

## Catalysts

- Continued growth in Net Interest Margin from shift to Traditional loans, despite low rate environment
- Strong recovery of loan originations following dip resulting from broker terminations in Q2 application falsification controversy
- Growing proportion of revenues from stable servicing fees, via growth in loans under admin

## Risks

- Potential overheating of overvalued Canadian housing market, leading to: i) Market-wide slowdown in originations; or ii) Increasing credit losses among existing loans
- Potential further BoC rate cuts putting downward pressure on rates and interest margins

## Financial Summary

### Bond Overview

(as of Dec. 31, 2015)

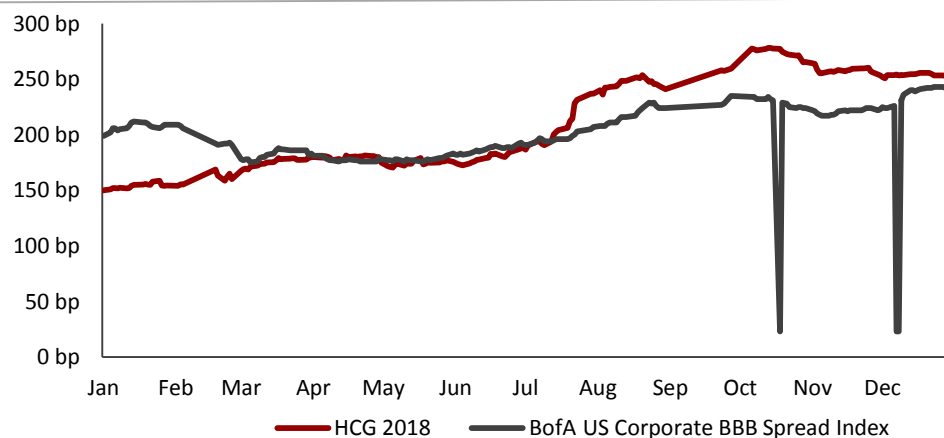
Price	100.50/100.86
Coupon	3.40%
YTM	3.14%
G-Spread	254 bp
Modified Duration	2.73
Amount Outstanding	300mm
Rating (S&P/DBRS)	BBB/BBBH

### Financials

(values in C\$m)

	LTM	2015E	2016E
<b>Net Revenue</b>	574	586	632
<i>% Growth</i>	2.5%	2.1%	7.9%
<b>Net Interest Income</b>	477	476	503
<i>% Growth</i>	3.8%	(0.2%)	5.7%
<b>Servicing Fees</b>	81	87	92
<i>% Growth</i>	13.8%	7.4%	5.8%
<b>Tier 1 Common Equity</b>	18.1%		

## Bond G-Spread and Rating Category Performance



## Position Snapshot

Average Cost	\$102.31
# of Units	240
Value Invested	\$24,220
Portfolio Weight	4.82%
Position HPR	1.7%
Corp Index HPR*	2.2%
Excess Return	(0.5%)

All figures in CAD

\*Corp Index: 100% FTSE TMX Canada All Corporate Bond Index.



# Home Capital Group 3.4% 2018

## Investment Thesis

- Shift to more stable revenue streams:** Increased securitization of Accelerator loans and their resulting off-balance sheet treatment allows HCG to grow total loans under administration and thus servicing fees while continuing to expand lending capacity for more profitable Traditional loans
  - Servicing fees, a stable, low risk revenue stream, continues to grow as a proportion of HCG's income, increasing from 24.0% to 27.7% YoY in 2015
  - Traditional loans target borrowers of higher credit quality and have lower LTV ratios (<80%) than Accelerator loans. As a result of being originated for longer terms and possessing lower funding costs, NIM continues growing in a low rate environment that's challenging rivals
- Strong credit fundamentals:** HCG's strong risk management is being overlooked due its operations in the non-prime mortgage market. The company's main risks are mitigated as follows:
  - Funding risk: 2015 acquisition of CFF Bank granted Schedule 1 status, allowing HCG to offer CDIC-backed deposits and significantly increase the marketability of new deposits programs
  - Credit risk on uninsured mortgages: reduced by strategic client targeting and property selection, along with a lower-than-peers average LTV ratio of 73.7%
  - Interest rate risk: hedging limits the impact of 100 bp shift to ~3% of net interest income
- Attractive valuation:** The market continues to overlook HCG's superior operating and financial metrics compared to prime and specialty lenders (see comparables table below)

## Analysis of Performance

HCG 2018's performance this year was significantly affected by the Q2 falsification issue. Over the course of July, HCG revealed a sharp Q2 decline in originations, caused by the termination of 45 brokers for falsifying income information on applications. This caused the spread to spike 50 bp over the course of July, continuing to a high of 278 bp in October. In our assessment, however, this widening was an overreaction. Not only did the loans originated by these brokers represent only an 8% fraction of HCG's portfolio, but 60% of them were insured. In addition, management demonstrated prudence by immediately launching an accelerated process to collect income information for affected loans. Importantly, we did not believe the incident was indicative of widespread problems at the company.

Our stance was confirmed by Q3's release, which indicated that 90% of mortgages reviewed thus far are eligible for renewal. Indeed, market fears are now fading as well, with spreads compressing ~10 bp since the Q3 release and 24 bp since mid-October. Going forward, we remain confident that our thesis on HCG still stands and expect the spread to tighten from its current level of 254 bp.

## Valuation Summary

As of December 31, 2015	Market Cap (\$		Operating Line Items		Leverage	Bond Valuation	
	Bn)	NIM	Efficiency Ratio	NPL Ratio	Tier 1 Cap Ratio	DBRS	G-Spread
Equitable Bank (EQB 5.399% 2017)	0.8	1.8%	32.8%	0.46%	13.5%	BBBL	283
First National (FN 4.01% 2020)	1.0	0.9%	35.9%	-	-	BBBL	331
<b>Specialty Lender Mean</b>	<b>0.9</b>	<b>1.4%</b>	<b>34.4%</b>	<b>0.46%</b>	<b>13.5%</b>	<b>BBBL</b>	<b>307</b>
Bank of Nova Scotia (BNS 2.37% 2018)	69.7	1.5%	53.3%	0.91%	11.9%	AA	93
Royal Bank of Canada (RY 2.26% 2018)	105.1	1.5%	46.6%	0.46%	11.6%	AA	90
CIBC (CM 1.7% 2018)	35.0	1.8%	62.0%	0.62%	12.6%	AA	97
Toronto-Dominion (TD 2.17% 2018)	93.0	2.0%	60.6%	0.60%	11.5%	AA	89
Bank of Montreal (BMO 2.43% 2019)	44.6	1.5%	68.7%	0.93%	11.4%	AA	102
<b>Prime Lender Mean</b>	<b>69.5</b>	<b>1.7%</b>	<b>58.2%</b>	<b>0.70%</b>	<b>11.8%</b>	<b>AA</b>	<b>94</b>
<b>Home Capital Group (HCG 3.4% 2018)</b>	<b>2.0</b>	<b>2.3%</b>	<b>32.2%</b>	<b>0.33%</b>	<b>18.0%</b>	<b>BBB</b>	<b>254</b>

# Iron Mountain 6.125% 2021

## Company Overview

- Iron Mountain (IRM) is a REIT specializing in records management and physical storage with operations in 36 countries, assisting more than 156,000 organizations, including 94% of the Fortune 1000
- Revenue generation is fueled by a combination of rental and service revenue. Rental revenue is earned on a per cubic foot of storage basis, while service revenue is created through pick-up, delivery, and destruction of stored documents
- It is expected that IRM will finalize its acquisition of Recall in early 2016. The merged company will control 65% of the global records management market

## Catalysts

- Recent REIT conversion has not received broad market recognition. As IRM is added to REIT indices, it should result in an increase in institutional interest
- Consolidation of operations and financial position following the Recall acquisition should significantly improve IRM's operating and credit metrics
- Increase in regulatory storage requirements in Emerging markets following the trend seen in developed markets

## Risks

- Earlier-than-expected industry shift resulting in a reduction in physical storage needs despite favourable regulatory requirements
- Management's inexperience with REIT status could potentially result in violation of REIT requirements leading to loss of status

## Financial Summary

### Bond Overview

(as of Dec. 31, 2015)

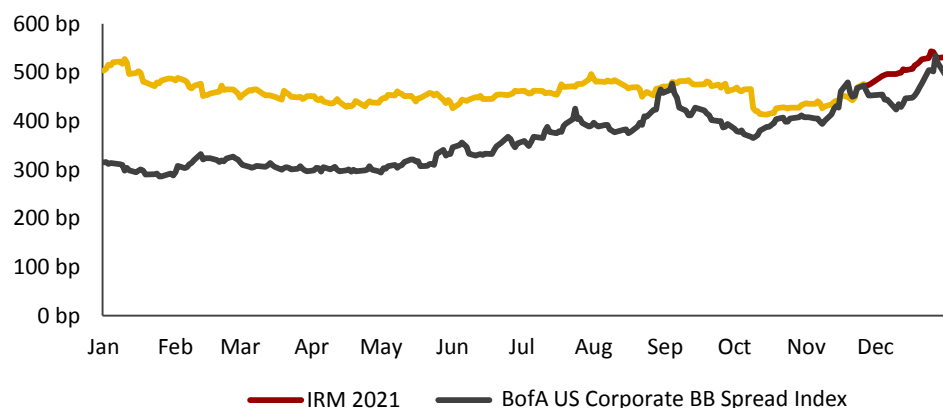
Price	99.00/103.00
Coupon	6.125%
YTM	5.50%
YTW	5.20%
G-Spread	463 bp
Duration	4.62
Amount Outstanding	200mm
Rating (S&P/Moody's)	BB-/Ba3

### Financials

(values in C\$mm)

	LTM	2015E	2016E
<b>Revenue</b>	\$3,033	\$3,025	\$3,104
<i>% Growth</i>		(0.3%)	2.6%
<b>Operating Income</b>	\$544	\$566	\$632
<i>% Margin</i>	17.9%	18.7%	20.4%
<b>Capex</b>	\$287	\$264	\$207
<i>% of Revenue</i>	9.5%	8.7%	6.7%
<b>Debt / EBITDA</b>	5.3x	5.5x	4.7x

## Bond G-Spread and Rating Category Performance



## Position Snapshot

Average Cost	\$102.99
# of Units	150
Value Invested	\$15,269
Portfolio Weight	3.04%
Position HPR	-1.0%
Corp Index HPR*	0.0%
Excess Return	(1.0%)

All figures in CAD

\*Corp Index: 100% FTSE TMX Canada All Corporate Bond Index.

# Iron Mountain 6.125% 2021

## Investment Thesis

- 1. Acquisition of Recall extends durability of business:** Strategic acquisition of Recall will significantly improve operating performance and credit quality moving forward
  - Recall offers IRM increased geographic diversification into four new markets while cementing their global market share
  - The equity financing nature of the deal is attractive to DCM and will lower IRM's leverage. With \$155 mm in expected synergies, we see opportunity for significant improvements in credit fundamentals going forward
  - With a Debt/EBITDA ratio under 3.0x, the acquisition of Recall is projected to bring IRM's consolidated Debt/EBITDA ratio down to 5.0x
- 2. Tangible assets with excess capacity provides substantial recourse:** Real estate portfolio with minimal mortgages offers protection in the event of default
  - IRM currently owns 36% of real estate with a goal to increase ownership to 50% by 2020, and seeks global diversification of real estate in major markets
  - IRM holds approximately \$3.7 Bn in real estate assets with only \$300 mm in mortgages and \$2.6 Bn in financial debt, giving IRM a strong financial position to cover their liabilities
- 3. Attractive valuation:** The market is overlooking IRM's superior operating and financial metrics compared to self-storage and industrial REITs (see comps table). The market is likely also concerned of a potential shift away from paper record keeping. We do not see this as a major concern due to favorable regulation requiring long-term record keeping

## Analysis of Performance

During 2015, the G-spread on IRM 2021 widened by close to 40 bp following general weak performance in the REIT space. As creditors, we believe that the market overreacted in the case of IRM, considering the company's favorable fundamental profile relative to other REITs. With no other major record-management REITs as direct comparables, IRM is typically compared to industrial and self-storage REITs. Meanwhile, when comparing operating and credit metrics, IRM outperforms its counterparts, with higher per square foot rent, less maintenance Capex, longer term leases and higher client retention.

On December 21<sup>st</sup>, 2015, we initiated our position in IRM 2021 at a spread of 460 bp. While the spread widened to 498 bp by year-end, we remain confident in our thesis and expect to see the spread at around 300 bp by the end of 2016 based on comparable analysis.

## Valuation Summary

As of December 31, 2015	Market Cap (\$Bn)	Operating Metrics		Credit Metrics		Bond Valuation	
		Operating Margin	Capex/Sales	Net Debt / EBITDA	Int Coverage	S&P Rating	G-Spread
Sovran (SSS 5.54% 2021)	4.2	39.1%	103.7%	4.1x	3.4x	BBB-	233
CubeSmart (CUBE 4.8% 2022)	5.2	24.5%	111.2%	4.8x	1.6x	BBB	198
<b>Self-Storage Mean</b>	<b>4.7</b>	<b>31.8%</b>	<b>107.5%</b>	<b>4.5x</b>	<b>2.5x</b>	-	<b>210</b>
DCT Industrial (DCT 4.5% 2023)	3.1	20.2%	140.2%	6.8x	0.8x	BBB-	215
Duke Realty (DRE 3.875% 2021)	6.7	22.2%	48.6%	7.5x	0.7x	BBB	149
<b>Industrials Mean</b>	<b>4.9</b>	<b>26.0%</b>	<b>94.4%</b>	<b>7.1x</b>	<b>0.8x</b>	-	<b>182</b>
<b>Iron Mountain (IRM 6.125% 2021)</b>	<b>5.4</b>	<b>18.7%</b>	<b>9.0%</b>	<b>5.3x</b>	<b>2.1x</b>	<b>BB-</b>	<b>498</b>

## Graduating Class of 2015

**Alexandra Witteveen**

BCom Graduate  
Credit Suisse  
Calgary

**Alyssa Obert**

BCom Graduate  
J.P. Morgan  
New York

**Andrew Marcovitch**

BCom Graduate  
BofA Merrill Lynch  
Palo Alto

**Belal Yassine**

BCom Graduate  
RBC Capital Markets  
Toronto

**Colton Dick**

BCom Graduate  
CPP Investment Board  
Toronto

**Daniel Kraminer**

BCom Graduate  
RBC Capital Markets  
New York

**Daniel Sorek**

BCom Graduate  
TD Securities  
New York

**Debra Kelsall**

BCom Graduate  
Goldman Sachs  
New York

**Edouard Gaudry**

BCom Graduate  
BofA Merrill Lynch  
Toronto

**Jeremy Kertzer**

BCom Graduate  
RBC Capital Markets  
Calgary

**Joe Kaprielian**

BCom Graduate  
BMO Capital Markets  
Toronto

**Xavier Le Sieur**

BCom Graduate  
BofA Merrill Lynch  
Montreal

## Graduating Class of 2014

**Alan Ang**

BCom Graduate  
Bell  
Montreal

**Alexandre Castonguay**

MBA Graduate  
Intact Assurance  
Montreal

**Angel Bohorquez Colombo**

MBA Graduate  
PSP Investments  
Montreal

**Alexander Ohrn**

MBA Graduate  
Affiliated Managers Group  
London

**Alexis Lemieux-Cardinal**

BCom Graduate  
FactSet  
Toronto

**Anna Wright**

BCom Graduate  
BP  
Calgary

**Faicy Aboobacker Hussein**

MBA Graduate  
Pride Financial Assets  
Dubai

**Mak Doric**

BCom Graduate

**Michaela Hirsh**

BCom Graduate  
J.P. Morgan  
New York

**Mohammad Chowdhury**

MBA Graduate  
RBC  
Toronto

**Nicholas Bigelow**

BCom Graduate  
CIBC World Markets  
Toronto

**Nicholas Di Giorgio**

BCom Graduate  
J.P. Morgan  
New York

**Pengchao Liu**

MBA Graduate  
BCA Research  
Montreal

**Rene Boissonnault**

BCom Graduate  
RBC Capital Markets  
Toronto

**Rami Karabibar**

BCom Graduate  
Warburg Pincus  
San Francisco

**Samantha Fu**

BCom Graduate  
Cornerstone Research  
New York

**Sanja Vicentijevic**

BCom Graduate  
bclMC  
Victoria

**Shuang Yun**

MBA Graduate  
Jarislowsky Fraser Ltd  
Montreal

**Simon Bibeau**

BCom Graduate  
Goldman Sachs  
New York

**Stefano Reghelin**

MBA Graduate  
Royal Bank of Scotland  
Milan

## Graduating Class of 2013

**Alan Vergel de Dios**

BCom Graduate  
Stifel Financial Group  
Baltimore

**Alejandro Cardot**

MBA Graduate  
Private Family Office  
Caracas

**Ali Abdullah**

BCom Graduate  
Sapphire Group  
Pakistan

**Andy Macdonald**

MBA Graduate  
AGF Management  
Toronto

**Antonio Piazza**

BCom Graduate  
MBA  
Harvard Business School

**Cedric Garnier-Landurie**

BCom Graduate  
Chevrny Capital  
Montreal

**Emily Ren**

BCom Graduate  
RBC Capital Markets  
Toronto

**Fei Qi**

BCom Graduate  
BMO Capital Markets  
New York

**Ivan Di**

BCom Graduate  
RBC Capital Markets  
Toronto

**Jimmy Xie**

BCom Graduate  
Facebook  
Menlo Park

**Karolina Kosciolk**

BCom Graduate  
Prime Quadrant  
Toronto

**Meghan Chen**

BCom Graduate  
Student  
Oxford University

**Michael Commisso**

BCom Graduate  
BCA Research  
Montreal

**Mohammad Awada**

BCom Graduate  
PSP Investments  
Montreal

**Noah Senecal**

BCom Graduate  
Scotia Capital  
Montreal

**Rafael Barroso**

MBA Graduate  
JoMedia Inc.  
Montreal

**Shawn Raza**

MBA Graduate  
CIBC World Markets  
Toronto

**Simon Bouchard**

BCom Graduate  
Goldman Sachs  
New York

**Zeeshan Maqsood**

BCom Graduate  
Cardiant  
Montreal

## Graduating Class of 2012

**Adam Duffy**

BCom Graduate  
MBA  
Yale University

**Brendan Simeson**

MBA Graduate  
The Panel  
Dublin

**Graham Litman**

BCom Graduate  
Bell  
Montreal

**Jakub Kucmierz**

MBA Graduate  
PSP Investments  
Montreal

**Johnson Peng**

BCom Graduate  
ONEX  
Toronto

**Marc-Antoine Allen**

BCom Graduate  
CPP Investment Board  
London

**Matthew Corbett**

MBA Graduate  
PSP Investments  
Toronto

**Max Adelson**

BCom Graduate  
Fidelity Investments  
Toronto

**Molly Newborn**

MBA Graduate  
CCFL Investments  
Cupertino

**Nicolas Bellemare**

BCom Graduate  
Fidelity Investments  
Toronto

**Phillip Levy**

BCom Graduate  
CPP Investment Board  
Toronto

**Roberta Klein**

MBA Graduate  
Prime Quadrant  
Toronto

**Ryan Mead**

BCom Graduate  
PSP Investments  
Montreal

**Shimone Slomowitz**

BCom Graduate  
TD Securities  
Calgary

**Yael Klein**

BCom Graduate  
Prime Quadrant  
Toronto

## Graduating Class of 2011

**Amirali Assef**

MBA Graduate  
Standard Life Investments  
Montreal

**Gregory Randolph**

BCom Graduate  
Baupost Group  
Boston

**Jamie Tucker**

BCom Graduate  
Birch Hill  
Toronto

**Mark Li**

BCom Graduate  
PSP Investments  
Montreal

**Matthieu Boulianne**

BCom Graduate  
National Bank  
Montreal

**Michal Marszal**

MBA Graduate  
Sectoral Asset Management  
Montreal

**Tigran Karapetian**

BCom Graduate  
Picton Mahoney  
Toronto

**Yuangyuou Yu**

MBA Graduate  
Air Canada Cargo  
Montreal

## Graduating Class of 2010

**Bronwyn James**

BCom Graduate  
Equinox Fitness  
New York

**Brian Rosen**

MBA Graduate  
Rosen Partnership  
Montreal

**Daniel Peretz**

BCom Graduate  
McGill Medical School  
Montreal

**Emir Coscum**

BCom Graduate  
Torch Partners  
London

**Erdel Altintas**

MBA Graduate  
Turk Telecom  
Turkey

**Fatoumata Diana**

BCom Graduate  
MBA  
Cambridge University

**Gabriel Bonnel**

BCom Graduate  
Morgan Stanley  
London

**Hadi Kamzi**

MBA Graduate  
BMO Capital Markets  
Toronto

**Jason Kirsh**

BCom Graduate  
Waratah Advisors  
Toronto

**John Tarraf**

MBA Graduate  
TD Securities  
Toronto

**Jehangir Vevaina**

BCom Graduate  
Brookfield Asset Management  
Toronto

**Kyle Marta**

BCom Graduate  
Picton Mahoney  
Toronto

**Lincoln Zheng**

MBA Graduate  
UNB  
New Brunswick

**Neil Cuggy**

BCom Graduate  
Culiniste  
Montreal

**Philippe Morrissette**

BCom Graduate  
BCA Research  
Montreal

**Raja Uppuluri**

MBA Graduate  
CIBC World Markets  
Toronto

**Sarah Mahaffy**

BCom Graduate  
Credit Suisse  
New York

**Shu Wai Chi**

BCom Graduate  
HSBC  
Toronto

**Thibaud Sonntag**

BCom Graduate  
Studio Canal  
Paris

## Disclaimer

---

The Desautels Global Equity Fund and the Desautels Fixed Income Fund (hereafter: the Desautels Funds), together with Desautels Capital Management Inc., have been established as a pedagogical venture in order to offer students in the Investment Management Program in the Desautels Faculty of Management at McGill University some meaningful and realistic experience of the investment management industry and of investment research and analysis by working for Desautels Capital Management Inc. All outstanding shares of Desautels Capital Management Inc. are owned by McGill University. Desautels Capital Management Inc. has a separately constituted board of directors, all of whom are independent from McGill, and constitutes a separate legal entity having responsibility for its own affairs. The role of McGill University towards Desautels Capital Management Inc. is limited to the following activities: (i) appointing independent directors to Desautels Capital Management Inc.'s board of directors; and (ii) providing limited financial resources and support to Desautels Capital Management Inc., such as office space and allowing certain of its officers and employees to serve as officers of Desautels Capital Management Inc. or to carry out certain other functions.

Neither McGill University nor the Board of Governors of McGill University has the authority or power to act on behalf of Desautels Capital Management Inc. or the Desautels Funds, or to incur any expenditures on behalf of Desautels Capital Management Inc. or the Desautels Funds. Neither McGill University nor the Board of Governors of McGill University shall be liable for any debts or obligations of Desautels Capital Management Inc. or the Desautels Funds. McGill University is not involved in the daily activities of Desautels Capital Management Inc., including making investment decisions, and therefore does not take any responsibility for Desautels Capital Management Inc.'s activities. More specifically, McGill University has no liability under the Units, does not guarantee or otherwise stand behind the Units nor does it guarantee performance of the Desautels Funds. Any function or activity of Desautels Capital Management Inc. carried out by individuals who are also officers or employees of McGill University is carried out exclusively in the name of Desautels Capital Management Inc. and McGill University shall have no liability as a result thereof.

Neither the information nor any opinion expressed in this Annual Report constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g. options, futures, warrants, and contracts for differences). This Annual Report newsletter is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in

financial instruments and implementing investment strategies discussed or recommended in this Annual Report and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this Annual Report.

All opinions, projections and estimates constitute the judgment of the author as of the date of the newsletter and are subject to change without notice. Prices also are subject to change without notice. Desautels Capital Management Inc. is under no obligation to update this Annual Report and readers should therefore assume that Desautels Capital Management Inc. will not update any fact, circumstance or opinion contained in this Annual Report. Neither Desautels Capital Management Inc., nor any director, officer or employee of Desautels Capital Management Inc. accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this Annual Report or its contents and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

### Program Partners

