2018 YEAR END LETTER

January 22, 2019

A year ago, we wrote that the capital markets party would soon end given that high valuations for most financial assets were vulnerable in the context of rising interest rates, modest growth and U.S. trade wars. Throughout 2018, the US equity market marched upward and onward, driven by President Trump's tax cuts, while global markets stalled. This "disconnect" between the US and the rest of the world was bound to end and did so abruptly and with brutality in October as talk of inflation and synchronized global growth turned to that of an impending recession. This U-turn unleashed an avalanche of selling across global equity markets during the last quarter of 2018, with never-before-seen speed and depth as investor sentiment turned on a dime from euphoria to fear.

The pull-back in equity prices was amplified by computer-driven algorithmic program selling, high frequency trading, momentum strategies, quantitative models, the liquidation of several large hedge funds, and the indiscriminate selling of baskets of stocks held in ETFs triggered by panicky and leveraged retail investors, as well as tax loss selling. It is estimated that 85% of trading volume had nothing to do with actual company fundamentals, a fact born out by the equally rapid rebound in stock prices being experienced by global equity markets thus far in 2019. It appears that "the herd effect" has only gotten bigger with the growth in automated trading and ETFs, leading to more pronounced periods of over and undervaluation. This suggests that markets are becoming less efficient, creating opportunities for active portfolio managers going forward.

CANADIAN EQUITY

During the fourth quarter of 2018, our Canadian Equity Fund decreased **-12.4%** versus -10.1% for the TSX. Our underperformance was mainly due to indiscriminate selling across all sectors which dragged down small and mid-cap stocks more than their larger cap brethren in the index, compounded by tax loss selling. While we outperformed the TSX during previous market declines in the 1st and 3rd quarters of 2018, there was no place to hide in the 4th quarter. For the year, the Fund declined by **-13.6%** net of fees and expenses (**-12.1%** on a gross basis) versus -8.9% for the TSX Composite total return including dividends. The good news is that as of the writing of this letter, equity markets are rebounding and the Fund is up around **+6%** year-to-date.

Since inception in July 2006, our Canadian Equity strategy has produced a cumulative net return of **+179.4%,** more than double the +77.4% for the TSX. A $100,000 investment on July 1, 2006 (two years before the financial crisis) would be worth $279,400 today, representing an annual compound net return of **+8.6%** over the past twelve and a half years, versus +4.7% for the TSX. Measured in terms of "value added" active net returns, **we have generated +3.9% per year more than the market's +4.7% annual return** during this period**.**

A few bright spots during 2018 were:
Neulion (+108%): Digital technology provider of live video streaming services was acquired by Endeavor.
CGI Group (+22%): World leading IT consulting firm posted a record backlog and increasing profits.
Badger Daylighting (+19%): Hydrovac excavation company continues its rapid expansion in the U.S.
Baylin Technologies (+11%): Global leader in wireless antennae made several transformative acquisitions.
Goodfood Market (+8%): Canada's leading meal kit provider is quickly growing its subscriber revenues.

During the year we gradually redeployed cash by adding new positions such as **CCL**, **Stella Jones**, **Dollarama**, **New Flyer, Blackberry, Pollard Banknote** and **ATS Automation**, at valuations we consider reasonable, however with the relentless selling pressure towards year-end, it was difficult to predict when prices would bottom. Given the ongoing economic and geo-political uncertainties, equity markets are likely to remain volatile, so we continue to be very selective. We consider our portfolio defensive in nature with low exposure to cyclical or economically sensitive sectors relative to the market. While we should have done better in 2018, we believe that many stocks in our portfolio are oversold and that, in due course, value will surface as it did during 2016 and 2017. Wealth creation requires taking a patient long term view to investing and keeping emotions at bay.

US EQUITY

US markets finally saw the return of volatility in 2018. After a strong start in January, February saw our first correction in some years. Markets then resumed their climb, hitting new highs in the summer. The final quarter of the year saw the first bear market since 2009, with pretty much everything getting hit whether merited or not. Our portfolio fared better than most, seeing a loss for the year of **-1.7%** compared to a loss of -4.4% for the S&P500 and -11% for the small cap Russell 2000, putting us well ahead of our target blended average. We did so by holding large cash balances and judiciously taking profits in our winners earlier in the year.

Our best source of returns during the year was exiting certain long-term holdings. We sold out of our positions in companies such as **Dillard**'s, **Freidman Industries** and **Iradimed** during the spring and summer as we felt these companies were fully valued after moving up to our target price. We like to think we do not get wed to our investments, and when they reach fair value, we sell them. The only exception would be for phenomenal businesses that can grow almost indefinitely. A steel company and department store obviously don't qualify. This profit taking helped set us up for the volatility to come at the end of the year, where we picked away at some new positions and increased our weighting in some defensive names.

One of these new positions is **Yatra**. Yatra is the second largest online travel agent (OTA) in India. It would be similar to Expedia or Booking.com in North America. Yatra is still a small fast growing company, but we like their prospects very much. One of the first things people do when entering the middle class is to start to travel. And in a country like India, many will start traveling using apps on their phones. We saw this dynamic play out with China over the past decade and believe India's turn is next. The macro tailwinds are good, but beyond that we think an eventual takeout is likely. Booking.com has a presence in India, but not being local it has been slow going. In early December, Agoda, the South East Asian division of Booking, announced a partnership with Yatra where they would use its Indian hotel inventory to sell to their client base. Such partnerships often precede an outright acquisition as the companies get to know each other. We think such is the case here and increased our position size after the announcement as the stock price went down with the rest of the market.

Heading into 2019 we continue to be cautious. Markets have staged a nice rally in the first few weeks of the year and our portfolio has climbed in similar fashion. Yet there are warning signs that the economy may be slowing as the effects of Trump's tax cut fade and the impact of the Fed balance sheet reduction ramps up. Thus, we continue to favour defensive holdings and maintaining a high cash balance until better situations present themselves, as they invariably do.

CANADIAN FIXED INCOME

Our fixed income portfolio finished the year on a weaker note, though we still managed to outperform the indices on a gross basis. During 2018, our bond portfolios returned **+1.5%** before fees and cash drag, with individual client returns net of fees approximating between 0% and +0.5%. The Canadian Universe Bond Index returned +1.4% and the Canada Hybrid Bond Index returned +1.2%. Many of the portfolio changes that we made over the past year helped lessen the blow from a tough fourth quarter, though we are satisfied with our positioning headed into 2019.

In 2017, our preferred share holdings were large contributors to our outperformance, and we discussed reducing our weightings in our letter, which we did but not by enough. This year, the preferred share index dropped about 10% to levels that we found quite attractive again, with large, safe companies offering dividend yields between 5.5% and 6%. We increased our preferred share holdings in the fourth quarter in our taxable accounts as we expect a nice rebound in 2019. Every few years the preferred market, being less liquid, is subject to such volatility, exacerbated by tax loss selling and ETF outflows and inflows. In 2015, the preferred share index was down 15%. That was followed by rallies in 2016 and 2017 that averaged 10% per year. We expect the same snap-back this year, and so far, January has been off to a good start.

In our traditional bond holdings, corporate credit spreads (the interest rate differential between a corporate bond and a government bond) finally widened back to historical levels from the record tight spreads at the start of 2018. That causes bonds you already own to drop in price but makes new issues more attractive as you get a higher yield. The safer "Investment Grade" corporate bonds that we have been buying throughout 2018 vastly outperformed our "High Yield" holdings. We are glad we have been making the shift from a higher yield portfolio to a more balanced portfolio as our higher rated bonds performed well.

That's not to say this is a permanent shift. We always look at the markets and try to buy what's cheap and sell what doesn't make sense to us. Last year we looked at corporate spread levels and deemed we were not being sufficiently compensated for the risk and decided to start upgrading our bond portfolios. This past fall we saw what was transpiring in the preferred share market and thought that spreads and yields were too high given that the issuers are safe companies with extremely low risk of bankruptcy. Our job is always an ongoing one of evaluating the different markets and sectors while judging what is expensive and what is cheap. We then make a decision on where best to be positioned.

We enter 2019 thinking it is still better to be defensive. At some point we may sell our safest bonds with low yields to buy higher yielding bonds with more attractive risk/returns characteristics. Our judgement tells us that now is not the time, though we may get that opportunity soon. Thus, expect us to continue buying a mix of corporate bonds with a blended yield in the 5% to 6% range.

THE MACRO ECONOMIC ENVIRONMENT

On January 9th the Bank of Canada responded to a deteriorating economic outlook for 2019 that capital markets began to anticipate in late 2018. Governor Stephen Poloz made the Bank's concerns clear by not only leaving its benchmark interest rate unchanged at 1.75%, but he also made clear that future rate hikes are on hold pending new data. Consumer spending, carrying the load for Canada's economic recovery after 2009, has been making progressively smaller contributions. Rising mortgage rates and tighter lending rules have been taking a toll on housing, and the weakened oil price and U.S. protectionist concerns have added to downside risks. In December, the U.S. Federal Reserve announced that future interest rate hikes would be put on hold as a result of stock market volatility and expectations of slowing growth. North America is now catching up with the softening economies elsewhere in the world, particularly in the EU, Japan and China, which account for a high percentage of world GDP and trade.

The key issue for investors at this point is how much of this deteriorating global outlook has been discounted after the sharp fall in stock prices late last year. The economic slowdown story is rapidly becoming old news and investors need to be looking ahead in anticipation of how events will unfold in six to nine months. The equity rally since the December lows does come from a very oversold market but it may also be starting to reflect better prospects in the second half of 2019. Already, 10-year government bond yields have declined since the peak in October last year (when markets were more concerned about rising inflation and an overheating economy) by about 50 and 45 basis points in Canada and the U.S., respectfully, to around 2% and 2.8% respectively. The bond market is clearly discounting a weaker economy and falling inflation, and indications are that interest rates will decline further. Both the Bank of Canada and the Federal Reserve's next major moves could well be to lower policy interest rates. Falling interest rates tend to raise P/E ratios which is bullish for equity markets. If this plays out, it would act as an offset to weaker earnings in the near term prior to a return to better economic conditions.

Two other clouds overhanging the markets have been the sharp decline in China's economic growth rate and the U.S./China trade dispute. On both issues there are growing prospects of improvement. China keeps increasing policy stimulus to get its growth rate back on track and there are clear signs that both the U.S. and China want to get a trade deal before the looming deadline at the end of February. Also, energy, particularly oil, is very important for the Canadian economy as a whole, even though western Canada has most of the production and bears the brunt of the impact. The price of oil got pounded down in the fourth quarter of 2018 for two reasons. First, Saudi Arabia was pressured by the U.S. to increase production to offset sanctions on Iranian production which never happened. Secondly, the sharp fall in global growth prospects triggered reduced expectations of demand. The price of Western Canadian Select (WCS) got pressured much further with a huge widening in the differential to the price of West Texas Intermediate (WTI) due to a lack of pipeline capacity to export it. During 2019, we should see a recovery in the WTI price as inventories get worked off and the WCS differential has already narrowed substantially due to production cuts forced upon Canadian producers by the Alberta government. This should help to lift all boats in the Canadian equity market.

At present, there is still a lot of uncertainty over how things will play out, as there always is during periods of transition. Volatility is likely to be with us for a while. However, there are positive signs developing which do not yet appear to be taken into account by many market participants. Even though the North American economy will probably slow further in the first half of 2019, much of that is probably discounted by the market which should benefit from a brighter outlook in the second half.

Stephen Takacsy Jordan Steiner Tony Boeckh