Quarterly Market Commentary

March 2017

2017 is off to a great start and the performance of our managed portfolios reflects these results. We are very pleased with how the portfolios are currently positioned and we are looking forward to the balance of the year.

Most investors would not be surprised if the strong stock market rally since November was followed by some degree of a stock market correction. It is our view that any correction will provide a buying opportunity in a bull market that we expect to continue until the yield curve inverts, an event which we see as being at least a few years away.

Late last year, we published a note describing two types of market corrections that might be seen in the first half of 2017. The first type of correction, which we suggested could begin in late January, would be based on the idea that the market would 'run out of buyers' as an overwhelming consensus would emerge that growth was reaccelerating. Global growth accelerated throughout 2016, but it wasn't until January of this year that most investors became convinced that global growth was indeed picking up on a broad basis. Instead of a correction in price, equity markets experienced a 'correction in time', as the S&P 500 traded sideways from mid-December through late January, allowing some time for fundamentals to catch up to price. In our view, the economic data flow was simply too positive, as evidenced by strong global economic surprise factors, to expect a material decline in stock prices.

Economic surprise factors are now finally starting to decline and will likely move towards zero over the next several weeks, partly because economists have revised economic forecasts higher, and partly because some measures of economic momentum have reached short term peaks. Signs of slowing economic growth are largely a base effect. Global Industrial Production (IP) momentum declined in January 2017 because January 2016 was the first month of strong sequential growth. The year/year calculation no longer has the benefit of the easy comparison against the weakness of the 2015 global inventory correction, so momentum declines. Base effects such as this often result in a momentum peak twelve months into a period of reaccelerating growth. Once all the data is in, we expect the global IP momentum peak will be seen in May of this year as the initial surge of global IP in January of last year was followed by sequential weakness in February and May (so two more easy comparisons to come). For us, these tentative signs of slowing momentum are not a cause for concern. Monthly data can influence market expectations, but it remains our view that annual average growth measures will accelerate throughout 2017 before peaking sometime in 2018.

The global Purchasing Managers' Index (PMI) is also showing some signs of an interim peak as the global aggregate was unchanged at 53.0 in March with only 11 of the 30 country PMIs we track showing gains in the month. We believe declining economic surprise factors combined with these tentative signs of declining global growth could contribute to a stock market correction, which we

would expect would bottom sometime in May. We would consider any correction to be a terrific buying opportunity as we believe that the next economic recession and associated bear market are years away.

We had some trades that we felt were worth noting from the first quarter. As you know, we engage a trim function to prevent a position from becoming too large or too small. This has proven to be an effective method to manage volatility for the portfolio.

Last quarter, we had to trim down our weighting for National Bank. We executed this reduction on February 14th at $58.12.

We also had to trim down our weighting for Premium Brands. We executed this reduction on March 28th at $82.15. This position has done very well for us as we initially added it to the portfolio on June 8, 2016 at $55.36. We continue to favour Premium Brands as we expect a combination of organic revenue growth, margin expansion, and mergers and acquisitions to deliver high double-digit earnings growth over our forecast horizon.

We sold our position in Home Capital Group on February 13th at $27.50. The Ontario Securities Commission had served the company with an enforcement notice over disclosure of problems with mortgage applications. We felt that this was risk where we did not want exposure. As the saying goes, "Where there is smoke, there is fire." Since we sold it, the company recently announced that the president and CEO was terminated and removed from the company's board and subsidiaries, effectively immediately. Our decision was validated and the share price closed for the month at $26.03.

It is also worth noting that we moved the proceeds from Home Capital Group to Algonquin Power Utilities. We purchased this position at $11.78 on February 13th and the share price closed at $12.70 on March 30th. Algonquin is a diversified company with extensive North American power operations (a combination of pure renewable and thermal energy sources) and a regulated utility segment that operates in 13 states. The company's utility businesses include natural gas distribution, water treatment and supply, and electricity distribution.

In our view, Algonquin offers a balance of accretive expansion opportunities and transparent dividend growth potential (we believe that management's annual 10% dividend growth target is sustainable over our forecast horizon). Management has demonstrated an ability to navigate across multiple regulatory environments. We believe that Algonquin offers a compelling valuation in the context of an extensive growth pipeline (via development activity, acquisitions, and utility rate base investments), conservative payout ratio, and manageable leverage.

Some of our names that we continue to hold and favour for 2017 include:

Alimentation Couche Tard
We believe that Alimentation Couche Tard is well positioned to benefit from stronger economic growth in the U.S. and Europe, and a weaker Canadian dollar. Organic growth momentum has been improving as the headwinds of the past few years (the economy and the tobacco industry) may now act as tailwinds. Same store sales growth has also been accelerating. Management have proven to be excellent operators, and have also been high successful and disciplined acquirers. Further growth through acquisition is possible.

Canadian National Railway
The company reported a strong fourth quarter and raised the dividend by 10%. Railways are a key component of the North American transportation infrastructure. They provide efficient long haul transportation of goods into the continent from ports, out from the centre of the continent to ports for export, and across the continent. Rational competition, scalar economics and virtual geographic monopolies help the industry achieve consistent moderate price increases. A focus on continuous improvement has helped the best operators such as CNR grow profitability and cash flow which is returned to shareholders in stock repurchases and increased dividends.

Canadian Tire
We continue to see the risk/reward profile of Canadian Tire as one of the more attractive within our coverage universe. We believe that the depressed Retail valuation will further improve as the company achieves our growth forecast, should it replace intercompany receivables with cash, and as it further monetizes its surplus real estate. In the meantime, we believe the material normal course issuer bid should provide downside protection to the share price.

Cogeco Inc.
As we have stated before, we still prefer Cogeco Inc. to Cogeco Cable. Voting control of Cogeco Cable rests within Cogeco Inc. via multiple voting shares held, and a new management services agreement that was signed in 2016 significantly increases the transfer of value from Cogeco Cable to Cogeco Inc. each year. Even if we attach zero value to either the radio operations or the annual stream of management fees, Cogeco Inc. shares still trade at a discount to the underlying value of the publicly traded subordinate voting shares in Cogeco Cable (4.7% discount). This discount is down significantly from late-2016 when it reached close to 15%, but we argue that there is still room to go (we do not believe that the stream of management fees or the radio operations are worth anywhere close to zero).

Enercare Inc.
The company reported a strong fourth quarter and increased the dividend by 4%. At the end of March, we saw Reliance Home Comfort was sold by Alinda Capital Partners to CKP (Canada) Holdings Ltd. In our view, this sale highlights a potential takeout value for Enercare, as Reliance Home Comfort is the primary competitor to Enercare's core Home Services business in Ontario (1.7 million rental customers versus 1.1 million rental customers at Enercare).

The equity value of the transaction is approximately CAD $2.8 bilion and we estimate that the total enterprise value for Reliance Home Comfort is approximately CAD $4.6 billion with approximately $1.8 billion of consolidated debt (the most recent available data point)[1].

In F2015, Reliance generated EBITDA of $313 million (source: DBRS) and, assuming annual EBITDA growth of 4-8%, we estimate F2017 EBITDA for the company to be between $338 – 365 milion. This implies an EV/F2017E EBITDA multiple for the transaction of 12.7-13.7x.

Recall that Alinda Capital Partners purchased Just Energy's NHS water heater rental business in June 2014 for 11.7x LTM EBITDA and purchase the UE Waterheater Income Fund in April 2007 for 10.6x LTM EBITDA.

Using the implied estimated sale price for Reliance Home Comfort, we estimate a takeout valuation for Enercare to be between $29.00 - $32.00.

While the current and precedent takeout multiples in the sector are positive indicators of the potential value of Enercare in a takeout scenario, we would be cautious applying these multiples as we do not anticipate a takeout of the company in the near-term.

Magna International
Magna increased their dividend last month by 10%. Magna offers a globally diversified exposure to the automotive sector, which we see as having a stable outlook in North America, a solid potential for growth in emerging markets and Asia, and prospects for a moderate recovery in Europe. We believe that at the same time, the stage is set for less volatile relationships between original equipment manufacturers and the tier one parts suppliers as parts suppliers take on increased responsibility for design and cost engineering. Magna is trading at a discount to its peer group and to its own 10 year average valuation.

New Flyer Industries
This has proven to be a great addition to the portfolio. We initially added New Flyer to the portfolio on November 10, 2016 at $37.93 and it closed at $49.08 on March 30th. New Flyer is generating strong free-cash flow currently, with its capital-light business model, and we expect this to continue in the near-term given a strong industry outlook, record backlog, and continued opportunities for cost rationalization and optimization as it consolidates its bus and coach operations. Furthermore, New Flyer has a demonstrated track record for creating value through disciplined M&A and we expect this will continue to be a part of the story going forward.

Royal Bank
The bank reported a strong first quarter and raised the dividend by 7%. We believe that Royal Bank represents a core holding in a Canadian equity portfolio. The bank generates consistent, strong retail results and the shift to more predictable corporate lending, underwriting and M&A revenue from pure trading revenues will likely support a premium multiple. Royal Bank is known for its strong global and profitable capital markets presence. Royal Bank also has a track record of generating above-average industry growth. Investing in Royal Bank provides shareholders with exposure to Canada's largest bank with high-quality operating segments across all business lines.

Suncor
Last month, Suncor announced an 11% dividend hike. Suncor remains our top pick among the integrated names for the following reasons: 1) the conclusions drawn from our free cash flow yield analysis were a clear positive, with Suncor ranking well on 2019 free cash flow yield. 2) Suncor should increasingly be benchmarked against the global majors, in our view. It generally ranks as superior on the basis of growth potential, sustainability, and RLI. 3) Suncor continues to represent good value.

TransCanada Corp.
Last month, TransCanada announced an 11% dividend increase. TransCanada has a strong incumbency in the two most prolific natural gas basins in North America (the Marcellus/Utica and the Montney), combined with access to large markets, in our view. Growing connectivity over time should provide customers with increasing optionality as it moves approximately a fifth of North American natural gas. The company's 91,500 km of pipelines have increasing value as new pipelines become more difficult to build, in our view. We believe that TransCanada's scale, energy infrastructure expertise, low-risk business model, and financial strength are competitive advantages when pursuing new assets. Investors also have an option in the Keystone XL project that should grow in value over the next year. Big picture, strengthening oil & gas fundamentals should benefit TransCanada's growth outlook and mitigate any impact that rising interest rates might have on sector valuations.

The Toronto-Dominion Bank (TD Bank)
Last month, TD Bank increased the dividend by 9%. TD Bank has operations in both Canada and the United States and is the second largest bank in Canada by market capitalization. With roughly one quarter of its net income generated by the U.S. division, it has the highest leverage to the U.S. economy and rising interest rates of any of the large Canadian banks. The U.S. Federal Reserve (Fed) has been clear in its intentions to continue on a path of increasing interest rates as quickly as

they see prudently possible given the underlying economic fundamentals. They are focused on bringing the discount rate to a "normal" level that would give them flexibility in the event of future market turmoil. TD Bank has recently underperformed its peers after the Canadian Broadcasting Corporation aired a television program alleging certain aggressive sales/management practices. The underperformance has led to TD trading at the widest discount to Royal Bank on a Price/Earnings basis that has not been seen in 10 years. With improving economic fundamentals set to drive strong growth in the second half of 2017 for TD Bank, we believe this multiple gap should compress as the year progresses. As a result, we believe TD Bank represents a good risk reward opportunity at this time.

If you should have any questions, or comments, we welcome any feedback. Finally, we are accepting new clients. If you know of any family, friends or colleagues who could benefit from our complete offering, we would be most grateful if you would pass our names on to them.

[1]Source: DBRS, as at December 30, 2015

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