Leon Frazer & Associates
INVESTMENT COUNSEL

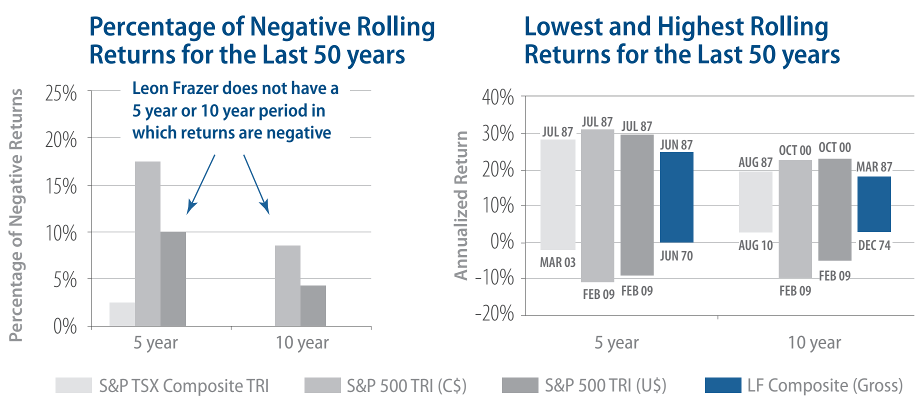
experience counts...
managing private clients' money for over 75 years

DECEMBER 2015

LEON FRAZER QUARTERLY REVIEW

Equity Market Commentary: A Brutal Year for Canadian Equities

THE S&P/TSX COMPOSITE TOTAL RETURN INDEX POSTED A -8.3% RETURN, the 9th worst on record since 1957. The S&P 500 Total Return Index fared better in the United States, up 1.4% in local currency, however when adjusted to Canadian dollars, the US market was up more than 20% for the third year in a row. After a record 19% decline in 2015, the Canadian dollar has decreased nearly 40% in the last 3 years. The Canadian market was the 3rd worst performing developed equity market in the world in 2015, ahead of only Greece and Singapore. Only 3 of the 10 market sectors registered positive returns last year, (Telecom, Consumer Staples and Technology) and just over 25% of stocks advanced, the second worst level in 20 years, with 2008 being the worst.



Source: Thomson Reuters

LONG-TERM OUTLOOK FOR CANADIAN MARKET MUCH MORE PROMISING

On a longer-term basis, things aren't quite as bleak. The Canadian market has handily outperformed the US market since 2000, both before and after currency adjustment. It continues to represent a strong group of businesses poised to support both the Canadian and global economies for decades to come, while rewarding investors with total return in the form of dividends and capital appreciation.

WHAT HAPPENED IN 2015?

Leon Frazer portfolios underperformed the benchmark for the second year in a row. This was not a surprise, as the Leon Frazer Equity Composite typically underperforms when growth sectors like Technology and Consumer lead. What was surprising, however, was that we underperformed in a down market, something that has happened only 3 times in our history. So we really have two issues to evaluate when looking at 2015. Why did Canadian equities underperform their American counterparts and why did Leon Frazer underperform the TSX Composite?

The short answer for the first question is oil. Oil prices declined precipitously in late 2014, staged a brief rally in mid-2015, then tumbled again, ending the year near the 2008 financial crisis lows. As sentiment towards oil prices got more pessimistic, so too did the global view on Canadian equities. With mobile capital and ever shortening time horizons, shares of fundamentally strong Canadian companies were sold so returns could be chased elsewhere. Canadian investors followed the herd and divested a record $10 billion+ of domestic equity mutual funds last year, exacerbating the performance differential. Finally, the Canadian dollar depreciated by the largest margin on record for a 1-year timeframe, adding return to unhedged foreign investments.

The answer to the second question is a bit more nuanced. The Leon Frazer Equity Composite outperformed the TSX Composite by nearly 30% on a gross of fees basis from 2008 – 2012. Since that time, the Leon Frazer Composite has given back ~11% of this outperformance. No strategy can outperform in all markets and our strategy tends to underperform during the part of the cycle when investors chase growth. Technology and Consumer stocks were the best performers in both Canada and the United States last year, but are underrepresented in Leon Frazer portfolios due to their lack of significant dividend yield. Somewhat surprisingly, pipeline shares, which have led the outperformance in our portfolios over the last decade, were the worst performing area in our portfolio in 2015, down more than 20%. Despite this recent weakness, pipeline shares are still the 4th best performing sector

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> *"The Canadian dollar depreciated by the largest margin on record for a 1-year timeframe"*

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A Brutal Year for Canadian Equities

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in Canada over the past 10 years, with a 9.75% annualized return and representing the highest dividend yield and dividend growth in our portfolios. We do not view this growth as being directly affected by oil and gas prices given the contracted nature of their businesses and the growth of energy demand in North America and abroad.

WE ANTICIPATE A BETTER YEAR IN 2016

We expect a better year in 2016 for both the Canadian market and our strategy. Underpinned by stronger economic growth in the US and abroad, we think the Canadian economy will get through the weakness stemming from low oil prices.. The drop in the Canadian dollar helps fuel domestic export growth and lessens the blow from the drop in oil prices for Canadian energy producers. Oil prices will remain challenged in the first half of 2016 as Iranian production is set to enter the market at the end of Q1, however declining production, primarily in the United States, and continued demand growth should provide support to prices in the back half of the year. Canadian equities are looking cheap, especially on a currency adjusted basis and we would expect global investors to take notice as the year progresses.

CONTINUE TO RECOMMEND CANADIAN DIVIDEND-PAYING EQUITIES

For Canadian investors with Canadian liabilities, we continue to recommend a portfolio primarily constructed with Canadian dividend-paying equities. 2015 was the exception and not the rule. It is crucial to remember one's long-term investment objectives during periods when performance turns down. Unhedged US returns have been fantastic over the last 4 years as the US market finally broke above a 13-year trading range, while their currency simultaneously snapped back from the worst financial crisis since the Great Depression. Unfortunately, these returns are in the rear view mirror at a time when Canadian investors are racing to exit Canadian investments. The attached chart shows that unhedged US equity returns can dramatically turn against a Canadian investor as well, similar to the middle of the last decade. In fact, over the last 50 years, investing money in the United States actually adds volatility for a Canadian investor on a 5-10 year basis and dramatically increases the likelihood of having a negative 5 or 10-year total return.

2015 was a brutal year for Canadian investors; especially those in a dividend-based strategy like ours. We continue to steadfastly believe in the time-tested strategy we are employing on behalf of clients and the companies we hold. The first part of the recovery is almost always the steepest. Quality companies that pay sustainable dividends do not remain out of favour for long. We would like to wish our clients a happier 2016 from an investment prospective. We appreciate your trust, especially during times when patience is tested. ●

Fixed Income Commentary

"The preferred equity market recovered somewhat from lows set in September"

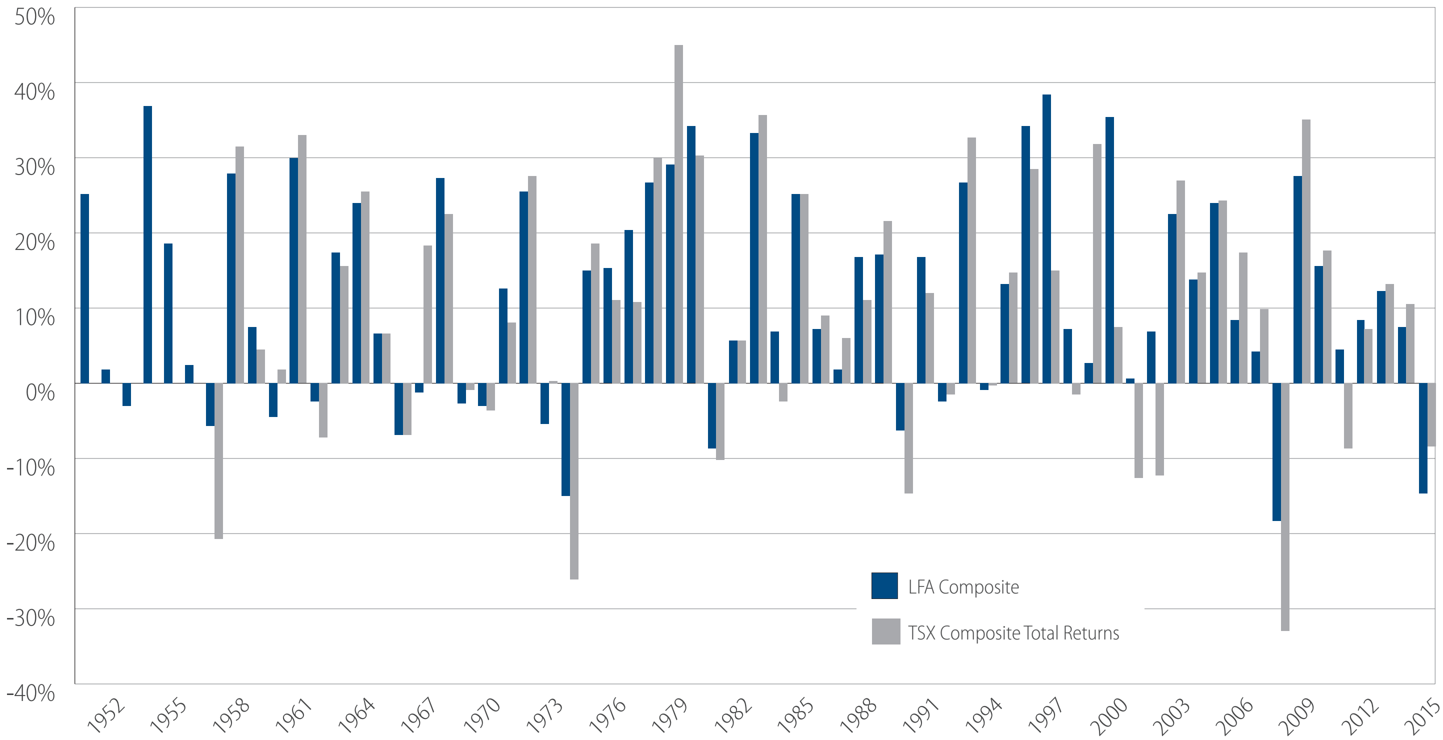
Although the preferred market rebounded strongly with the S&P/TSX Preferred Share Total Return Index up 6.8% on the quarter, it was still very weak for the year, down 15.0%. The FTSE TMX Short and Mid Term Bond Total Return Indices returned a more muted 0.5% and 1.0% respectively on the quarter, but also a more satisfying 2.6% and 4.9% over the course of 2015.

Due in part to the weakness of the Canadian economy, yields have continued to decline, with the current 10-year Government of Canada yielding 1.39% compared to 1.43% on September 30, 2015. On a full-year basis, and as a result of a weak Canadian economy and two Bank of Canada rate cuts, the 10-year rate dropped 40 basis points from the 1.79% posted on December 31, 2014. For the full year, corporate bonds performed slightly better than government bonds at shorter terms (1 – 5 years), but performed worse at mid and long terms, with a difference of almost 3.0% (4.48% for governments versus 1.51% for corporates) for long-term bonds with 10+ years to maturity.

The JOV Leon Frazer Bond Fund had positive performance in the third quarter, however it underperformed its benchmark both last quarter and over the past year, due to an above benchmark weight in corporate bonds and a lower than benchmark portfolio duration. We maintain our view that rates will ultimately rise from what we believe are artificially low levels. As a result, we remain hesitant to chase yield by increasing the term-to-maturity of the Fund.

The JOV Leon Frazer Preferred Equity Fund had positive performance in the third quarter, but underperformed the Index. Over the entire year, however, the Fund performed better than the Index. The preferred equity market recovered somewhat from lows set in September as pension funds, mutual funds and retail investors started coming back due to favourable risk/reward characteristics, especially considering many preferred shares yield more than 5% versus sub-2% for most Government of Canada bonds. A higher than normal cash position for most of the quarter and a lower than benchmark weight in fixed resets were the main causes of our negative performance versus the Index. In the JOV Leon Frazer Preferred Equity Fund, we are likely to take advantage of the sell-off in rate reset securities as we believe they should perform better than perpetual or retractable preferreds when interest rates rise. ●

Spotlight: Calendar year returns since 1950



Source: Leon Frazer & Associates Inc.
LFA composite returns are shown gross of fees

- **Since 1957, there have been 17 down years for the TSX; the average return for those years is -10.0%**
- **Since 1951, there have been 16 down years for the Leon Frazer Equity Composite; the average of those years is -6.3%**
- **In the last 20 calendar years, the TSX Composite Total Return Index has declined 6 times; the Leon Frazer Equity Composite has declined only twice during the same timeframe**
- **2015 was the third worst calendar year return for the Leon Frazer Equity Composite. Our 3-year return following our two worst years (2008 and 1974) was more than 50%**

Leon Frazer Timeline

HISTORY OF THE CANADIAN DOLLAR

Sept. 1939	War is declared; the Canadian dollar is fixed and exchange controls are imposed
July 1946	The dollar is revalued upwards by approximately 9% against the US dollar
Sept. 1950	Canadian dollar depreciates. The federal government cancels fixed parity and currency appreciates
Aug. 1957	The Canadian dollar hits a peak of $1.06 US
May 1962	The government establishes a new par, fixing it at 92.50 cents US with a fluctuation band of 1 per cent
May 1970	The government floats the Canadian dollar amid a growing budget surplus and rising inflation
April 1974	The dollar hits a high of $1.04 US
Nov. 1979	Canadian currency slides to 84 cents US
Feb. 1986	The dollar hits a record low of 69.13 cents US
Dec. 1989	The currency rebounds somewhat to close the decade at 86 cents US
1990s	The dollar weakens during the tech boom of the 90s, closing the decade at 69.29 cents US
Jan. 2002	The currency hits a record low of 61.79 cents US
Nov. 2007	The dollar soars in value through the year, reaching an all time high of $1.10 US before starting its descent in 2008
Dec. 2008	The dollar loses 18.6% against the US dollar due to a collapse in commodity prices
April 2010	The dollar touches parity for the first time in 20 months
Dec 2015	The Canadian dollar depreciates by the largest margin on record in a 1-year timeframe; 6 of the 10 largest moves in the Canadian dollar have occurred in the last 10 years

Source: Bank of Canada, The Globe and Mail

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Note as of December 31st 2015 the Ontario Securities Commission requires that we disclose the definition of book cost as follows: Book Cost in your Quarterly Statement is the total amount paid to purchase a security, including any transaction charges related to the purchase, adjusted for reinvested distributions, returns of capital and corporate reorganizations.