Leon Frazer & Associates
INVESTMENT COUNSEL

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

JUNE 2016

LEON FRAZER QUARTERLY REVIEW

Equity Market Commentary: An Event Filled Quarter

OIL PRICES AND THE CANADIAN EQUITY MARKET CONTINUED THEIR RESPECTIVE ASCENTS IN Q2, up 26.1% and 5.1% respectively. For oil, this was the strongest quarter since 2009, as fundamental supply/demand dynamics continued to improve. The S&P 500 gained ground as well, up 2.5% in local currency, however the Canadian dollar appreciated up 0.6% against the US dollar, taking away from returns on foreign equities for Canadian investors.

SERIES OF EVENTS IMPACTS QUARTER

Q2 was eventful from both a macroeconomic and geopolitical perspective. The quarter began with a stunning special meeting of major oil producers in Doha, Qatar. Saudi Arabia unexpectedly changed course at the 11th hour, thwarting a major production freeze agreement with Russia and OPEC producers (excluding Iran) that had been aiding the oil price recovery through the end of March. In May, the US Federal Reserve abruptly adjusted guidance toward raising interest rates, sending interest rate traders into a frenzy of adjusting positions. The so-called "Fed Futures" went from a near zero probability of an interest rate increase before September to a greater than 50% chance in just days. Later in the month, a weak US jobs report sent interest rate expectations tumbling back down, however uncertainty remained.

In Canada, tragic wildfires severely curtailed Canadian oil production and economic growth in May. June brought another OPEC meeting that was much more constructive than the "Doha debacle," a decision not to raise interest rates by the US Federal Reserve and finally, the highly anticipated UK referendum on the status of their membership within the European Union.

GLOBAL EQUITY MARKETS PROVED RESILIENT

The surprising decision by UK voters to leave the European Union sent brief shockwaves through global financial markets, most acutely felt in the currency market. Global equity markets proved resilient and climbed at the end of the quarter, all but erasing the two days of losses following the "Brexit" decision. We won't know the ultimate effects of this decision for some time, however we doubt they will have any impact on our investment strategy. Our short-term reaction to Brexit was to take advantage of an opportunity to put a small amount of cash to work in accounts where warranted.

In almost every case, the short-term reaction to the events above was almost immediately reversed. The failed Doha meeting did not cause oil prices to retrace back to their lows, the Fed didn't raise interest rates in June, and "Fed Futures" are now pricing in the probability of a cut in interest rates, not an increase. Finally, the dreaded Brexit decision did not send equity markets into a downward spiral, as the TSX, S&P 500 and even the London-based FTSE all closed higher on the month.

BEWARE OF THE SENTIMENT OF THE MOMENT

The modern news cycle can have adverse effects for the long-term investor, while fueling the short-term trading industry's thirst for tradable catalysts. Daily prices for marketable securities are determined by the diverse motivations of participants. Time horizons can extend from fractions of a second (high frequency traders) to several decades; however intra-day transactional activity is overwhelmingly weighted to those with time horizons that do not extend past the next change in season. Fundamentals such as the ultimate outcome of Brexit will no doubt have an effect on the global economy. Short-term market participants will continue positioning and repositioning for the possible outcomes as more information becomes available. Eventually the market will price securities correctly for whatever the actual impact of Brexit ends up being. In the meantime, a multitude of other events will present their own reactions and outcomes that will affect securities prices on an ongoing basis, making it impossible to accurately quantify the true effect.

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An Event Filled Quarter

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STAYING THE COURSE

As long-term investors charged with the task of navigating our clients' assets, we cannot be taken off course by singular events, no matter how exciting or scary they may seem in the moment. We aim to purchase long-term viable businesses with sustainable cash flows and dividends that can help weather whatever short-term events grip the markets. Our love for "backbone" of the economy businesses and the way they fit with our end goals is well documented.

Recent events have brought into question our ongoing position in resource producers with so-called "hard assets." Low cost producers of commodities with relatively inelastic demand profiles have upside exposure to global growth and development while simultaneously hedging inflation risks stemming from the devaluation of paper currencies. Cash flows and dividends from commodity producers, while variable, are longer term in nature relative to the shorter cycle cash flow trends that exist in most Technology, Health Care and Consumer companies. Recently, commodity prices have been weak owing to the somewhat artificial US Dollar strength, sluggish global growth and ample supplies. Longer-term though, we view commodity producers as solid complementary insurance against inflation, while also offering upside linked to continued global growth and economic development.

STEADY HAND APPROACH

Performance in the first half of 2016 has somewhat validated our steady handed approach in 2015. We remain focused on managing our clients' assets with their long-term goals in mind and will do our best to ignore events that could cause performance drain owing to capitulation based primarily on the sentiment of the moment. ●

Fixed Income Commentary

"We remain extremely wary of the present risk/reward tradeoff that exists in bonds and have minimized client positions and durations to the maximum extent possible"

Fixed Income markets were volatile again in Q2 as a slew of events sent benchmark government bond yields on a roller coaster ride. Early in the quarter, yields rose as recessionary fears dissipated and economic data strengthened in both Canada and the United States. In May, Janet Yellen, the US Federal Reserve Chair, unexpectedly turned hawkish and stated a June interest rate hike was not out of the question. Later in the quarter, weak US employment numbers and uncertainty surrounding the United Kingdom's decision to leave the European Union tempered the enthusiasm for an interest rate increase. Bond yields closed the month at new all-time lows, with Government of Canada 10-year bonds at a paltry 1.05% and a record of >50% of European sovereign bonds of all maturities trading at negative yields.

The JOV Leon Frazer Bond Fund was up 1.3% in the second quarter, however it marginally underperformed our benchmark (50% FTSE TMX Short-Term Bond Index and 50% FTSE TMX Mid-Term Bond Index) due to a lower than benchmark portfolio duration. Our short average term to maturity in the Fund has marginally affected performance YTD, costing us 0.5% relative to the benchmark, however it offers significant protection should rates bounce from these unprecedented levels.

The JOV Leon Frazer Preferred Equity Fund was up 3.3% during the quarter, handily outperforming the S&P/TSX Preferred Share Total Return Index. The preferred equity market continues to be volatile as investors struggle with valuing rate reset preferred shares in an environment where yields on government bonds continue to decline. When considering that many preferred shares now yield more than 5% versus less than 1% for comparable Government of Canada bonds, we continue to see value here, especially given the beneficial tax treatment for preferred share dividends relative to interest income. A lower than benchmark weight in fixed reset preferred shares drove our outperformance versus the Index in Q2.

We remain extremely conservative in our fixed income positioning in order to provide portfolios with reasonable income and volatility protection, with minimal interest rate risk. Bonds have been in a bull market for over 3 decades, fueled by economic growth and interest rate normalization following the inflationary mistakes of the 1970s. Recently, the bond market rally has been fueled by the more ambiguous actions of central banks and flight to safety demand. We remain extremely wary of the present risk/reward tradeoff that exists in bonds and have minimized client positions and durations to the maximum extent possible to protect our clients' capital, both on an absolute basis and especially relative to inflation. ●

Spotlight: The End of the World? Again?

Dona Eull-Schultz

I often muse about what I have learned during my 30 plus years in the investment industry. Far too many times, I've anticipated the end of my career due to market corrections, corporate failures and global upsets. Yet here I am, all these years later, still in the business. Life has gone on and the markets continue to climb higher.

INSTANT INFORMATION PLAYS HAVOC ON RATIONAL THOUGHT

Before this age of instant information dissemination, events were still large, but seemed to occur less frequently and with much less fanfare. It's not that colourful commentators wouldn't proclaim an imminent market correction (google the name: Joe Granville), or talk of an impending catastrophe (remember Y2K?). It's that these personalities didn't always catch the attention of the average investor or the media. And even when they did, investors weren't immediately compelled to rush out and sell their carefully planned investment holdings.

Today, we are an event-driven, news hungry society, fed by social media experts citing reasons to buy and sell 24/7. Pending Fed meetings, OPEC meetings, and the antics of European countries are now everyday conversations around our dinner tables. Facts have been supplanted with noise. Volumes of information rather than value of information is the norm. And the problem is, this promotes emotional reaction, rather than pragmatic rationale thought.

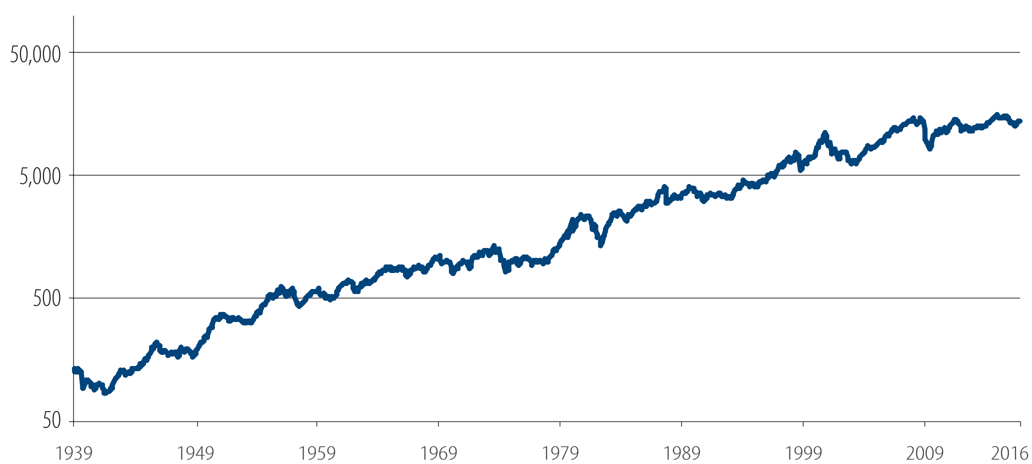
LONG-TERM PERSPECTIVE STILL KEY

Investment managers are expected to predict the news, react to the news or comment on the news. When did the day-to-day news displace wisdom counsel and judgment on how to articulate and achieve one's investment goals? When did we lose the discussion about what is important and the path to achieving it? How does one make sense of it all?

In my view, the purpose of investing is to convert hard earned money into long-term sustainable assets with an increasing income stream to provide for retirement or pass along to future generations. Envision planting a garden. You carefully plan it out. You plant diversified materials, depending on what works for your space, then you sit back and let it grow. The garden's results are measured over years, not on a monthly basis. Sometimes harsh weather creates havoc and your garden requires extra attention or just some well-timed patience. But over time, the garden flourishes. Maybe not all of the original plantings last, but the strong thrive, and your continued commitment makes the end result so much more satisfying.

"In my view, the purpose of investing is to convert hard earned money into long-term sustainable assets with an increasing income stream to provide for retirement or pass along to future generations"

S&P/TSX Composite Price Index since 1939



Source: Thomson Reuters

TIME IN THE MARKET VS MARKET TIMING

Those events we talked about earlier? They still occur and you can't time or necessarily predict them. You also can't worry about every single one. From a long-term perspective, most events prove to be insignificant to the process of growing capital over a lifetime, as you can see in the chart depicting the S&P/TSX Composite Price Index since 1939. Clearly, time in the market works significantly better than market timing… and it also lets you enjoy your life a whole lot more. ●

Leon Frazer Timeline

SUMMER AND **WINTER** OLYMPICS SINCE 1939

1940
1944 } 1939–1945 World War II cancels the scheduled 1940 and 1944 Olympics
1948 London, United Kingdom; **St. Moritz, Switzerland**
1952 Helsinki, Finland; **Oslo, Norway**
1956 Melbourne, Australia; **Cortina d'Ampezzo, Italy**
1960 Rome, Italy; **Squaw Valley, California**
1964 Tokyo, Japan; **Innsbruck, Austria**
1968 Mexico City, Mexico; **Grenoble, France**
1972 Munich, West Germany; **Sapporo, Japan**
1976 Montreal, Canada; **Innsbruck, Austria**
1980 Moscow, U.S.S.R.; **Lake Placid, USA**
1984 Los Angeles, USA; **Sarajevo, Yugoslavia** (*now Bosnia and Herzegovina*)
1988 Seoul, South Korea; **Calgary, Canada**
1992 Barcelona, Spain; **Albertville, France**
1994 First separated winter Olympics, **Lillehammer, Norway**
1996 Atlanta, United States
1998 **Nagano, Japan**
2000 Sydney, Australia
2002 **Salt Lake City, USA**
2004 Athens, Greece
2006 **Torino (Turin), Italy**
2008 Beijing, China
2010 **Vancouver, Canada**
2012 London, United Kingdom
2014 **Sochi, Russia**
2016 Rio de Janeiro, Brazil

Source: www.encylopedia.com

Leon Frazer & Associates
INVESTMENT COUNSEL

Toronto
26 Wellington Street East, Suite 800
Toronto, Ontario M5E 1S2
toll free: 800-418-7518
tel: 416-864-1120
fax: 416-864-1491
e-mail: info@leonfrazer.com

Vancouver
475 West Georgia Street, Suite 540
Vancouver, British Columbia V6B 4M9
toll free: 866-266-4730
tel: 604-601-2088
fax: 604-601-2089
e-mail: info@leonfrazer.com

Calgary
645 – 7th Avenue SW, Suite 2400
Calgary, Alberta T2P 4G8
toll free: 844-538-3219
tel: 403-538-3219
fax: 403-262-8789
e-mail: info@leonfrazer.com

www.leonfrazer.com