

May 2017

Surprises are part of life, be prepared

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We strive to invest in high-quality, undervalued businesses. The challenge is that, occasionally, quality and value may deteriorate quickly, turning a fundamentally good investment into a bad one. It is impossible for any investor to be right 100% of the time. However, we take a controlled and measured approach to minimize volatility and we expect to generate consistent returns for our investors over their investment horizons.

We were recently affected by issues facing Canadian mortgage lender Home Capital Group, which was held in our Canadian Equity Alpha mandate. One of our portfolio management groups, QV Investors, had invested in shares of the company a few years ago after an extensive analysis of its operations, its industry and other factors. QV's research indicated that Home Capital was a high-quality investment due to its solid history of loan performance, stable funding access and high return of capital. However, the company's shares came under pressure on April 20, 2017 after Ontario's securities regulators released allegations claiming that the management of Home Capital had misled investors about a 2014 internal investigation into fraudulent mortgage applications. Generally, a lender like Home Capital earns a profit from making long-term loans financed by short-term borrowing – in this case, mortgages financed by high-interest savings accounts and guaranteed investment certificates. The news prompted depositors to begin withdrawing their money, effectively causing a “run on the bank” and putting pressure on Home Capital to raise capital from alternative sources. On April 26, 2017, the company announced an agreement with an institutional lender to provide emergency funding, which was good news, but it came with an interest rate of 10% per annum and an upfront fee of \$100 million. This “lifeline” kept the company liquid but at a significant cost to future earnings and shareholders' equity value.

The thesis that Home Capital was a high-quality and profitable company changed in a matter of days. In investment terms, this represents “single security risk” – a risk that is not related to the general tone of the markets or fundamentals of the sector or economy, but is specific to the operations of a company. We are well aware of the presence of this risk in any investment. Doing our due diligence can reduce, but not eliminate, company-specific risk. Another important way to manage this risk is by diversifying our investments. Since the current problems are specific to Home Capital, we believe it is unlikely the other companies we invest in will be affected.

We are, of course, disappointed by the performance of our investment in Home Capital. QV Investors has since sold its shares in the company as its quality has deteriorated significantly. We respect QV’s difficult decision. Home Capital is not an investment that QV would own based on current information and it is not an investment they should continue to hold simply because the portfolio already held the shares.

Diversification has protected our portfolios. We are pleased to report that our Canadian Equity Alpha portfolio held up strongly, even after the Home Capital shares were sold. The position in Home Capital was small relative to the portfolio’s other holdings, which performed well during this time. In April, Canadian Equity Alpha Corporate Class (Class W) returned 0.64%, compared to 0.44% for the S&P/TSX Composite Index. Over the long term, this mandate has also generated very attractive results as outlined below.

Class W Returns (in %) as at April 30, 2017	Year-to-date	1 year	3 year	5 year	Since Inception (6/1/2009)
Canadian Equity Alpha Corporate Class	2.8	14.3	5.0	11.3	12.9

Surprises can also be positive. In April, our International Equity Alpha mandate benefited from its holdings in Christian Dior Couture after LVMH Moët Hennessy Louis Vuitton announced it was acquiring all outstanding shares of Christian Dior Couture at a 15% premium.

Our portfolios have performed strongly in 2017. We are surprised by how resilient the equity markets have been, especially in response to negative news. While valuations of the markets have increased, our portfolios are not as exposed to market moves as portfolios that track the performance of an index. We are holding larger-than-normal amounts of cash to temper volatility and to take advantage of future opportunities. In our balanced portfolios, we also own asset classes such as government bonds and foreign currencies that, in general, are negatively correlated to stocks. They protect against the downside when equity market corrections surprise investors. Surprises are unavoidable and it is important to prepare for them, whatever they may be.

Combined top 15 equity holdings as of April 30, 2017 of the Evolution 40i60e Standard portfolio with Alpha-style exposure:

1. Microsoft	6. UnitedHealth	11. Walgreens Boots Alliance
2. Apple	7. Alphabet Class C	12. Comcast
3. Canadian Natural Resources	8. Tourmaline Oil	13. Wells Fargo
4. Atco	9. Chubb	14. Abertis Infraestructuras
5. Altagas	10. E-L Financial	15. Bank of Nova Scotia

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