Portfolio Commentary

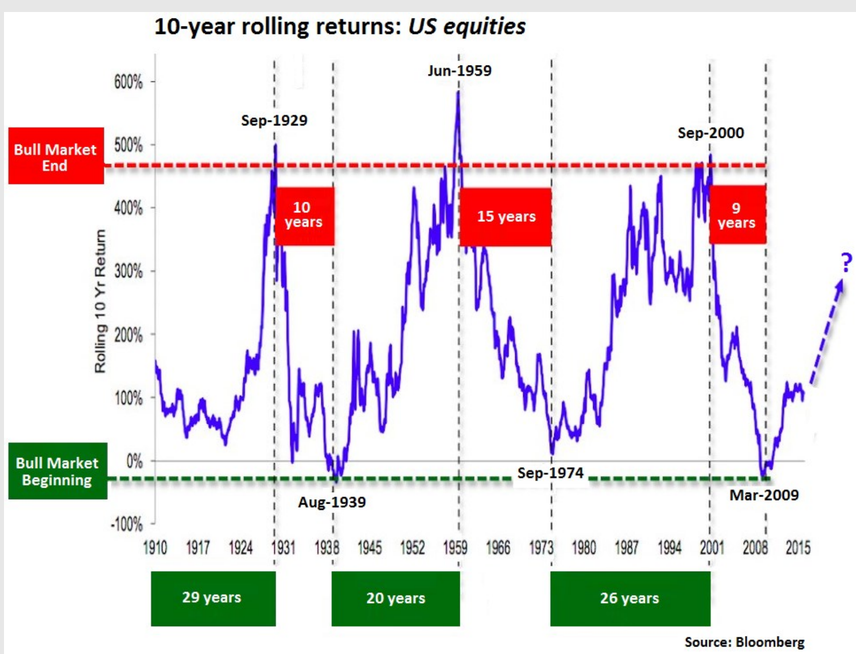
Fourth Quarter, 2015

The pause that refreshes

Twenty-fifteen was a forgettable year for all of the major asset classes: bonds returns were middling, the S&P 500 closed the year below where it started, and the unrelenting slide in energy prices helped weigh our stock market to a loss of more than 8%. On a price basis, US stocks have now treaded water for about 18 months and one has to go back more than two years to find a point when the TSX was meaningfully lower than it is today. Though frustrating, this condition is hardly out of character for equity markets, whose long term growth isn't delivered in a linear progression, but rather in fits and starts punctuated by significant detours along the way.

If there's upside to the recent period of stagnation it's that it effectively douses the well-worn admonition of recent years that stocks have run "too far, too fast" and helps to fortify the fundamental health of the market by ensuring that prices remain tethered to value. Recent equity malaise has brought the 5-year total return of the bellwether S&P 500 to about 12.5%, not alarmingly above its long term average, and its annualized 10-year return to just over 7%, well below the long run mean.

Taking this line of thought a step further, the chart below describes US bull and bear markets over the past century in terms of rolling 10-year returns; in other words, each point on the oscillating line represents the market's total performance (price and dividends) for the preceding decade.



Suite 1680, 1055 West Hastings St., Vancouver, BC V6E 2E9
Tel 604 669-3136 **Toll Free** 888 340-3136 www.**dixonmitchell**.com

DIXON MITCHELL INVESTMENT COUNSEL

As you can see, 10-year cumulative returns have tended to bottom around zero (much as we experienced six and half years ago), but usually only top out when the measure has reached 400-500%. As well, past rising periods have lasted 20-30 years, but have always included stretches when stocks aren't behaving according to plan *(it's undoubtedly during these intervals that wealth is shifted from impatient hands to strong ones)*. By this yardstick at least, the uptrend in stocks since the sub-prime crisis would go down as by far the shortest and smallest bull market in history, if it were to end today.

Understandably, lulls in equity performance increase an individual's urge to "do something", a compulsion often satisfied by exiting struggling markets with plans to jump back in when all is well and stocks are once again on the rise. While tempting, such a tactic presupposes that one can solve the enigma of market timing that has confounded traders and speculators since the beginning of organized exchanges and also flies in the face of abundant research showing that over activity is amongst the predominant reasons that the realized results of investors regularly fall short of needs and expectations. When philosopher Blaise Pascal offered that "all men's miseries derive from not being able to sit in a quiet room alone" he almost certainly wasn't thinking of investing, but his observation applies just as well here as it might to broader aspects of life.

Though we won't be attempting to outsmart the market's short term gyrations, pauses in its climb do provide unique opportunities to reflect, refocus, and fine tune portfolios to ensure that they are well positioned against the prevailing economic and business backdrop. In our case, this has meant reevaluating individual positions, both already owned and under consideration, as well as taking advantage of opportunities for tax management that have emerged during this period of equity consolidation. In our Canadian mandates, much of this work has been carried out in the energy component of portfolios.

As everyone is now well aware, the challenges faced by the energy industry have had a significant impact on the Canadian economy, our currency, and the TSX. The depth and persistence of the drop in oil prices caught nearly everyone – *governments, OPEC, portfolio managers and, of course, energy producers* – by surprise and has rapidly morphed from a cyclical downturn to a near existential threat for some parts of the industry. This upheaval has created a Darwinian landscape across the sector, where the strongest companies (those with conservative balance sheets, low cost operations, and long life assets) will survive and eventually thrive, while the rest are being forced to sell assets at otherwise objectionable prices and/or dramatically scale back operations. In rationalizing portfolio exposure to the group, our goal was to ensure that our holdings reside squarely in the first group, without any concern that they might wind up in the second. This process also allowed us to crystallize previously unrealized losses in mandates, dampening the effect of gains triggered earlier this year and in recent years past. The energy names that we believe meet the criteria described above and which we've kept in our institutional Canadian equity mandate are as follows:

Canadian Natural Resources – controls the largest land base in the Western Canadian Sedimentary basin, with its holdings characterized by their long lives, low decline rates, and stable output. The company has raised its dividend for 14 straight years and possesses the strength and flexibility to weather a sustained period of commodity price weakness.

Tourmaline Oil – also holds a long life asset base with a 50 year drilling inventory based on current activity rates. In the gas-weighted producer space, Tourmaline has amongst the lowest operating and capital costs, with year-over-year drilling costs falling by another 10% in 2015. Tourmaline's founders own more than 10% of the company and have purchased additional shares in each of the company's secondary offerings since its original listing.

Suncor Energy – Canada's largest integrated oil and gas company boasts negligible decline rates on its producing properties, relatively low sustaining capital requirements, and an extremely strong balance sheet. Suncor is committed to cost cutting and, even with today's extremely low oil price, it continues to generate free cash flow. Since 2011, the company has bought back $5.3bn worth of its own shares and returned an additional $4bn to shareholders through dividends; Suncor recently reaffirmed its $500m buyback program for next year and boosted its dividend by 3%.

Arc Resources – also holds a long life asset base and has been able to reduce costs by roughly 20% over the past year. Arc is known for its disciplined dividend policy and has recently used its strong balance sheet to opportunistically acquire additional land at deeply discounted prices.

Just as $100 oil set the stage for a price collapse by attracting new and unanticipated production, so too could $35 crude put in place the conditions for an opposite price reaction, as projects are cancelled, financing dries up, and upstart producers succumb to their meagre balance sheets. With the names above, we believe that our portfolios contain effective leverage to a potential turnaround, while curbing the impact of energy price weakness, should it persist.

In foreign allocations, alterations have been less sector-concentrated and geared more toward improving overall fundamental metrics. This has meant targeting select companies which enhance both the growth and value attributes of the portfolio and whose management teams have established records of operational excellence and capital allocation discipline. To make room for these new names, certain holdings have been liquidated, particularly those whose secular outlook had receded in recent quarters and those for which our models are showing possible pressure on upcoming earnings and cash flow growth.

Looking ahead, it wouldn't surprise us if stock market volatility and bouts of weakness were to persist in the months to come. That said, however, a similar gloomy feeling hung over stocks in the summer of 2011 when the S&P 500 and TSX plunged by 17% and 14% in a three week span as investors fretted over an expanding European debt crisis and signs that the nascent economic recovery was losing steam. Needless to say, individuals who abandoned their long term investment plans at that time would have sorely regretted their decision in the quarters to follow.