Leon Frazer & Associates
INVESTMENT COUNSEL

experience counts...
managing private clients' money for over 70 years

DECEMBER 2013

LEON FRAZER QUARTERLY REVIEW

Equity Market Commentary: A Promising Year Ahead

2013 WAS A DECIDEDLY POSITIVE YEAR FOR NORTH AMERICAN EQUITY MARKETS. The S&P 500 Total Return Index was up a blistering 32.4% while the S&P/TSX Total Return Index was up a respectable 13.0%. During the fourth quarter, the Canadian market returned 7.3% compared with 10.5% in the United States. The Financials sector now accounts for over 35% of the Canadian market and was the biggest positive contributor on the TSX, up nearly 24% during 2013. The Materials sector was the largest negative contributor on the TSX for the third year in a row, down 29%. Gold stocks, which are included in the Materials sector, were down 44% on the year.

FOCUS ON MULTI-DECADE TIME HORIZON

There has been much news made about the recent strong performance of US equities, up nearly 19%, on average, in Canadian dollars in each of the past 3 years. The Canadian market has been up just over 3%, on average, over the same period. It is easily forgotten however, that over periods of 10 and 15 years, the Canadian market has outperformed its US counterpart by 30% and 95% respectively. Over the very long term, the Canadian and US markets perform similarly, but over shorter periods, they tend to diverge. Our intention is to chart a steady course for our clients' portfolios using a multi-decade time horizon. Portfolios are constructed to continually participate in the success of the domestic Canadian economy through the backbone sectors (Utilities, Banks, Telecommunications, and Pipelines), as well as partaking in global growth through our weightings in Industrials, Energy and Materials.

RECORD NUMBER OF DIVIDEND INCREASES IN PORTFOLIO

Dividend growth was strong in client portfolios, with 74% of our core holdings increasing their dividends in 2013. This is the highest percentage on record since we started tracking these statistics in 2008. The portfolio weighted average dividend increase was slightly muted relative to 2011 and 2012 due to a surprise dividend cut from Encana at the end of the year. Since 2008, the weighted average dividend increase for our core holdings is just under 7% per year. We believe that growth in the total value of the portfolio is directly related to the rate of dividend increases and that is why we are comfortable with a 6%-9% annual total return expectation for equity portfolios. Remember that dividend stocks also include the added benefit of being significantly less volatile, with increased downside protection.

LOOKING AHEAD

As we look ahead to 2014, we expect another solid year for the Canadian equity market, but are more cautious on the US market given the rapid price appreciation during the last two years. We believe the US economy is poised to accelerate as the private sector is finally strong enough to withstand stimulus withdrawal and post 3%+ GDP growth. Canada is expected to grow more slowly. We are maintaining our 1-3% growth path for the Canadian economy as export strength from a softer Canadian dollar will be tempered by a cooling housing market and stimulus withdrawal.

Our view for the North American equity markets is the reverse of our economic view. Stock markets are a leading economic indicator. Although we believe economic growth in the US will outpace Canada, a lot of good economic news is already priced into the US market. Meanwhile, the Canadian market has

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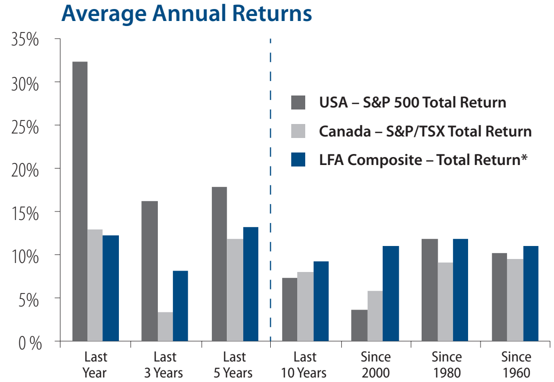
Average Annual Returns



Source: Bloomberg
**gross of fees*

> ***"Dividend growth was strong in client portfolios, with 74% of our core holdings increasing dividends in 2013"***

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A Promising Year Ahead

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a dividend yield that is a full 1% higher than the US market, and two of its three largest weighted sectors (Materials and Energy) posted decidedly negative returns for 3 straight years. These factors give us a healthy amount of optimism about Canadian market performance going forward in 2014 and beyond, despite a somewhat tepid economic backdrop.

"Our goal is to produce a consistent real return that compounds over time"

LEON FRAZER PORTFOLIOS POISED FOR A PROMISING YEAR

Turning to Leon Frazer portfolios, our clients should not be surprised to see their equity returns, after fees, slightly lagged the Canadian market in 2013. Our conservative nature forces us to endure periods of slight underperformance when the market climbs in order to protect more capital when the market falls. We have noticed a significant sentiment shift among the investing public from the fearful times of 2008-09 to a more aggressive stance now. We grit our teeth when we hear people talking about their recent outsized returns, without mentioning how their accounts did in 2008 or 2011. Fear and greed are the perpetual enemies of the average investor. It is our professional discipline to ignore both of these impulses. Our goal is to produce a consistent real return that compounds over time.

2014 is poised to be another promising year for Leon Frazer client portfolios. Bank valuations appear reasonable; energy infrastructure projects are finally coming online to relieve transportation bottlenecks; materials companies have endured a more than 50% drop in market capitalization in the last three years and solid dividend growth is expected to continue. Of course, our predictions could be wrong. The market could drop in 2014, as it tends to do every 4 or so years. Luckily, we always construct the portfolio by first asking, "what if we're wrong?" We feel this is the key to our excellent capital preservation statistics. Whatever comes, we will maintain our focus on increasing the income generated in client accounts, which leads to increasing account balances over time and do our best to ignore near-term stock market volatility, both positive and negative. ●

Fixed Income Commentary

Canadian fixed income markets provided mixed returns in 2013, with longer-term bonds fairing poorest. The DEX Short Term Bond Index provided a positive return of 1.7% while the Mid and Long Term Indices returned -0.6% and -6.2% respectively. In the fourth quarter, the DEX Short, Mid and Long Indices returned 0.8%, 0.4% and -0.2% respectively. The S&P/TSX Preferred Share Index returned -0.3% in the fourth quarter and -2.6% for the year.

"We expect a continued gradual rise in interest rates next year as we move closer to the removal of stimulus that was put in place during the credit crisis"

The Canadian yield curve steepened considerably over the year. Yields on two-year bonds began and ended the year at 1.13%, while yields on ten-year bonds rose 96 basis points to end the year at 2.76%. The Canadian central bank is expected to continue to keep administered rates at current levels through 2014, as is the US Federal Reserve. In December, the US announced they would begin to remove some of the stimulus currently being provided to the economy by reducing the amount of long-term bonds they buy in the market each month. When this tapering was first floated in May, bond yields rose dramatically and when the concept was quickly reversed, yields retreated somewhat. The formal tapering announcement in December was generally taken as a non-event as market participants are comfortable the US economy is indeed getting stronger and can withstand the gradual withdrawal of stimulus.

Provincial and corporate bonds outperformed federal bonds of similar term over the year, benefitting from the additional yield they provide and buoyed further by narrowing corporate credit spreads.

The JOV Leon Frazer Bond Fund performed well both in the fourth quarter and over the year, primarily because the term of the Fund was kept quite short throughout the year. The Fund also benefitted from the outperformance of the credit sectors. Although inflation levels are expected to remain benign, we expect a continued gradual rise in interest rates next year as we move closer to the removal of stimulus that was put in place during the credit crisis. The Fund will continue to favour short-term corporate bonds.

The JOV Leon Frazer Preferred Equity Fund had negative performance in the fourth quarter and over the year. Preferred shares prices, particularly those of perpetual shares, declined in the summer after the first discussions around the removal of stimulus. Although they consolidated somewhat through the fall, they were under more pressure at year-end for tax loss selling. Monies returned to investors from upcoming high coupon reset preferred share redemptions may provide support for the market. To ensure the Fund's holdings are diversified across many industries, it will remain underweight the Financial sector. The JOV Leon Frazer Preferred Equity Fund will remain underweight perpetuals as we expect them to underperform as interest rates rise. ●

Spotlight–Dividends: Another Passing Trend?

We all know investment trends come and go. In each of the past decades, one or two investment themes have dominated, many of them providing the basis for the various financial manias and asset bubbles we've experienced over the years.

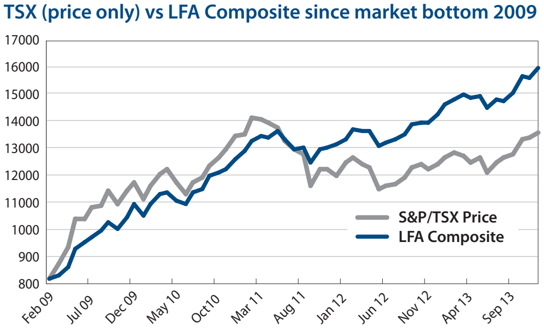
INVESTMENT THEMES OF THE DECADES

In the post war era of the 1960s, the focus was on large cap stocks, which offered solid growth and high dividend yields. By the 1970s, investors wanted nothing to do with stocks after a dramatic fall in the markets. Inflation became the all-consuming theme, as interest rates rose to 20% and unemployment reached double-digit figures. In the 1980s, the financial world was dominated by the Japan miracle, which drove up Japanese stocks and real estate prices. In the 1990s, the overriding theme was technology. Many of us can still remember investors getting caught up in dot.com mania, and the huge bubble in tech stocks. In the 2000s, China's economic ascendance defined the global financial markets, which culminated in a commodity boom and emerging stock markets.

DIVIDEND STOCKS GENERATING A LOT OF PRESS

Though it's too early to speculate on the dominant investment theme for the 2010s decade, dividend stocks have definitely been generating a lot of press. Since the market bottom in 2008, the Leon Frazer composite portfolio is up 97% versus 68% for the S&P/TSX Price Index. Since dividend stocks have outperformed the broader market over the past 5 years, some worry about the prospect of a "dividend bubble" and question whether dividend stocks are just another passing trend that will ultimately go out of favour.

TSX (price only) vs LFA Composite since market bottom 2009



Source: Thomson Reuters

Certainly no one can accuse Leon Frazer & Associates of being trend followers. We have adhered to the same investment strategy and philosophy since Leon first opened our doors in 1939. From the beginning, Leon realized the value of investing in dividend-paying stocks. Seventy-five years later, we still agree with his philosophy, and the numbers speak for themselves.

There's no doubt that dividend stocks have had a great ride lately and it's not surprising, considering the other options for income oriented investors in this environment. You get just about the same amount of interest from the bank as you do putting money under your mattress. And Treasury bond yields are so low, it's ridiculous to even think about locking up your money at 10 years for 2.7% per year.

LFA INCOME LATER PORTFOLIO DIVIDEND INCREASES

	2008	2009	2010	2011	2012	2013
# of companies in portfolio	30	30	27	27	27	28
# of companies that increased their dividend	19	13	17	21	21	22
% of companies that increased dividend	63.3%	43.0%	63.0%	77.8%	77.8%	78.6%
Weighted average portfolio dividend increase	14.1%	-4.3%	8.7%	10.7%	8.1%	6.7%
Average % increase of companies that increased their dividend	25.0%	8.4%	15.5%	13.7%	10.8%	8.1%

7.2% Annualized increase for 6 years
8.5% Annualized increase for 4 years
39% of holdings increased every year since 2007

DIVIDEND INCOME GROWTH KEY TO GENERATING STABLE, POSITIVE RETURNS

Dividend income growth is the key to generating stable, positive portfolio returns over time. In 2013, 79% of the equity holdings in the Leon Frazer Income Later portfolio increased their dividends by a weighted average of 6.7%. That's our highest percentage dividend increase on record since we started tracking these statistics in 2008. Over the past six years, the annualized weighted average portfolio dividend increase was 7.2%; over the past four years, the annualized increase was 8.5%.

"Since 1980, 73% of market appreciation can be attributed to increases in dividends"

DOES GROWTH MATTER?

Why does dividend growth matter? Since 1980, 73% of market appreciation can be attributed to increases in dividends. In short: increasing dividends leads to increasing share prices over time. And don't forget about the added benefits of dividend stocks which are less volatile, and exhibit better downside protection when compared to the broader market, not to mention the tax advantages relative to interest paying investments.

Dividend stocks may be popular today. They may even be the hot "new" investment theme of the decade. But to suggest they are a passing trend is definitely not something we at Leon Frazer would agree with. ●

Leon Frazer Timeline

EXTREME WEATHER EVENTS IN CANADA

DECEMBER 1939
Temperature drops to -42.2°C in Lethbridge, Alberta

DECEMBER 1944
Toronto's biggest single day snowfall, with 48 cm of snow falling in one day

JANUARY 1947
Prairie snowstorm rages for 10 days, burying towns and trains from Winnipeg to Calgary

FEBRUARY 1947
Temperature drops to -63°C in Snag, Yukon, the coldest temperature ever recorded in Canada

OCTOBER 1954
Hurricane Hazel strikes Southern Ontario, bringing 110 km/h winds and 285 mm of rain in 48 hours

APRIL 1967
A series of intense winter storms drops a record 175 cm of snow in Southern Alberta

MARCH 1971
Eastern Canada blizzard brings more than 61 cm of snow, along with 110 km/h winds, creating Montreal's snowstorm of the century

FEBRUARY 1982
PEI experiences 100 km/h winds and snowfalls of up to 60 cm

JANUARY 1989
Record wind chill in NWT when the -51°C temperature had a wind chill equivalent of -91°C

DECEMBER 1996
Two-day storm blankets Vancouver Island in 65 cm of snow

JANUARY 1998
Ice storm of the century leaves 100 mm of ice and nearly 1 million people without power in Ontario, Quebec and New Brunswick

JANUARY 1999
Toronto snowstorm lasts 11 days, dumping nearly a year's worth of snow in 10 days

SEPTEMBER 2003
Hurricane Juan slams Eastern Canada with 160 km/h winds, creating $100 million in damages

FEBRUARY 2004
White Juan hits five months later, leaving 50-70 cm of snow and paralyzing Nova Scotia

JUNE 2013
Calgary floods create $1.7 billion in damages, the costliest disaster in Canadian history

DECEMBER 2013
Ice storm leaves over 500,000 homes in Ontario and Quebec without power

Source: Environment Canada

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