Leon Frazer & Associates
INVESTMENT COUNSEL

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

MARCH 2016

LEON FRAZER QUARTERLY REVIEW

Equity Market Commentary: Recovery Well Under Way

WE CLOSED OUR FINAL COMMENTARY OF 2015 BY SAYING, "The first part of the recovery is almost always the steepest and quality companies that pay sustainable dividends do not remain out of favour for long." It is nice to see the recovery well underway after the first quarter of 2016. The S&P/TSX Composite Total Return Index gained 4.5% after a wild ride that saw the Index down more than 10% in the first two weeks of the year, only to recover strongly in the last 6 weeks of the quarter. The S&P 500 Total Return Index followed a similar pattern, closing up 1.4% in local currency, however the Canadian dollar also rebounded 6.4%, hurting US-denominated returns in Canadian accounts for the first time in recent memory.

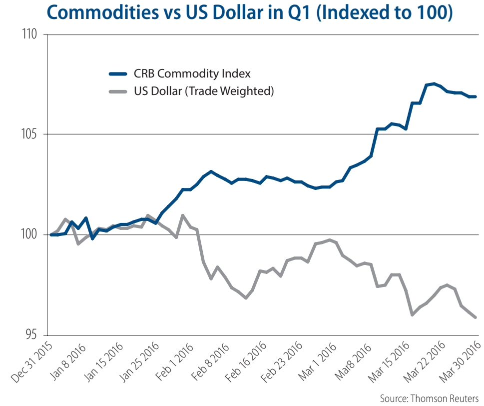
STRONG OUTPERFORMANCE IN THE LEON FRAZER PORTFOLIOS

The Banking, Pipeline, Telecommunication and Utility sectors all outperformed the benchmark during the quarter, leading to strong outperformance in the Leon Frazer equity portfolios. Valeant Pharmaceuticals endured an epic final collapse, falling nearly 90% from its mid-2015 peak with no tangible explanation of either what caused the collapse or what the likely catalyst is for a recovery. Pure Energy and Metals producers were the best performing sectors, while Health Care and Technology lagged, reversing the powerful flow of funds from the past 18 months. The NASDAQ remains the best performing major North American index on a 3-year basis, but it was the only one to post a negative Q1 2016 return in local currency terms, down 2.7% (-8.6% in Canadian dollars).

ECONOMIC DATA SURPRISES PUNDITS

The dreaded "R-word" made an appearance in February as pundits pointed to slowing momentum in the global economy, potentially leading to a recession in the United States and certainly in Canada. Since that time, economic data has surprised to the upside, with employment remaining strong in the United States. The lagged positive effect from the drop in the Canadian dollar seems to finally be trickling through the Canadian economy. Entering 2016, our view of the global economy and commodity prices was optimistic based on the fact we believed the US dollar was overvalued. The US Federal Reserve had guided to eight 0.25% interest rate increases by mid-2017 at this time last year, however only one increase was initiated in December 2015. The US dollar remained near its highs until the Fed finally adjusted their guidance to three 0.25% increases for the same period, including the one already completed. Since that time, the US dollar has fallen ~5% on a trade weighted basis, which helps emerging market economies by avoiding further currency depreciation and raising raw materials prices.

Commodities vs US Dollar in Q1 (Indexed to 100)



We remain skeptical of ongoing US dollar strength and are wary of the Fed's willingness to allow inflation to "overshoot" while they continue to stimulate the economy. Fortunately, we hold minimal long dated fixed income on behalf of clients and zero US treasuries, which will be the worst affected should current Federal Reserve policy create an inflationary accident. Our portfolios are positioned to protect clients from inflation by owning higher concentrations of conservative equities that can either pass through, or benefit from, inflationary pressure. Producers of hard commodity based assets are used as a complement in portfolios and provide

continued on page 2

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INSIDE THIS ISSUE

Recovery Well Under Way

continued from page 1

an additional layer of long-term protection from inflationary central bank policy.

WE REMAIN OPTIMISTIC ON OIL PRICE RECOVERY

"We are not surprised to see the quality businesses we own rebounding from an abnormally tough year of share price performance"

Oil prices experienced a volatile first quarter, initially driven down by fears of global oversupply with the lifting of sanctions in Iran, then recovering on optimism of a production freeze agreement between OPEC and Russia. Oil prices cratered in both mid-January and mid-February. Neither of these sentiment driven shifts had much long-term backing, however the fundamental picture continued to improve during Q1. North American drilling activity continued its precipitous drop and currently stands at roughly 25% of the 2014 peak, representing less than half the level needed to keep production flat on a go-forward basis. Despite the rise in oil prices in March, drilling activity continued to drop, reflecting the financial discipline being imposed on the North American energy market at current price levels. We remain optimistic on a continued oil price recovery through 2016 and into 2017. Hundreds of billions of dollars' worth of current and longer dated oil projects have been shelved to the detriment of the global oil supply curve and any further co-operation between cash strapped OPEC nations and Russia add upside to our view.

NEW PORTFOLIO SHIFTS

During the quarter, we undertook two minor portfolio shifts as opportunities arose. First, near the January lows, we added to our pipeline holdings as we felt share values had detached from the fundamentals of the underlying businesses, which have not meaningfully deteriorated despite commodity price weakness. More recently, following the significant bounce in commodity prices, we rebalanced our Energy producers in hopes of maintaining exposure to a recovery and increasing portfolio income, while eliminating some of our downside risk to both oil and gas prices nearer-term. Overall, we remain below the Energy weighting we had in September of 2014, but have added to our energy infrastructure (pipeline) holdings that constitute the entirety of our overweight position. A significant portion of these companies' revenues are fully contracted or regulated and go beyond oil and gas transportation and processing to things like power generation and residential natural gas distribution. So far, 2016 is off to a nice start. We are not surprised to see the quality businesses we own rebounding from an abnormally tough year of share price performance. ●

Fixed Income Commentary

"We maintain our view that rates will ultimately rise from what we believe are artificially low levels"

The preferred market continues to be uncharacteristically volatile, with a -13.7% return for January and February, followed by a 9.3% return in March, resulting in a -5.6% return for the quarter. The FTSE TMX Short and Mid Term Bond Total Return Indices returned a more "normal" 0.4% and 1.6% respectively on the quarter.

Yields have continued to decline, with the 10-year Government of Canada yielding 1.23% on March 31, 2016 compared to 1.39% on December 31, 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 has dropped 13 basis points from the 1.36% posted on March 31, 2015. With 10-year bond yields now trading below the 1.4% rate of inflation (as measure by the CPI index), we remain perplexed as to why investors are willing to earn a negative real rate of return on their money. For the recent quarter, corporate bonds performed better than government bonds all along the yield curve.

The JOV Leon Frazer Bond Fund had positive performance in the quarter, however it underperformed its benchmark due to a lower than benchmark portfolio duration. This hurt relative returns as the FTSE TMX Mid-Term Bond Index performed significantly better than the FTSE TMX Short-Term Bond Index. 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 negative performance in the first quarter, but performed in-line with the Index. The preferred equity market continues to be volatile as some investors struggle with valuing rate reset preferred shares in an environment where yields on government bonds continue to decline. However, considering that many preferred shares yield more than 5% versus sub-2% for Government of Canada bonds, we continue to see value. A higher than normal cash position and a lower than benchmark weight in fixed resets were offsets to our in-line 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: Beware of Ego

All investors can benefit from the saying, "if it seems too good to be true, it probably is." Becoming a cynic and digging deeper for the truth may be one of the most important pieces of investment advice you can adhere to.

THE COLLAPSE OF VALEANT

The collapse of Valeant Pharmaceuticals came quicker and was arguably more violent than even we expected. We first became skeptical of Valeant in the summer of 2014, when the company reached $150 per share, more than a 100% gain from a year earlier. Behind the scenes, in our investment meetings, we joked it should be called "Valeant Ponziceuticals." The company briefly retreated 25% to below $120 per share before rocketing upwards in 2015 to over $340 per share (boy were we wrong … temporarily!). Finally on August 7th of last year, shortly after Valeant eclipsed Royal Bank as the largest company in Canada, we made our thoughts public and published the following table questioning the valuation of the company at $325/share:

	Royal Bank of Canada	BCE Inc.	Valeant Pharmaceuticals
Market Cap ($Billions)	106.24	44.42	113.93
Price to Earnings	11.35	18.68	106.26
Price to Book	2.02	2.97	16.6
Dividend Yield	4.18%	4.93%	0.00%
No of Employees	78,000	57,234	16,800
Weight in S&P/TSX index	6.06%	2.56%	6.17%

as of August 7, 2015
source: Thomson Reuters

THE DANGER OF RIDING AN INVESTMENT WAVE

We all know what happened next. Allegations of suspect drug pricing and accounting policies followed by accounting restatements led to a jaw dropping 90% collapse to below $35/share in early April. To be sure, the drop quietly stung many investment managers who bought into the company because of its outsized effect on relative performance. Even though the company paid no dividends, Valeant found its way into a few Canadian dividend mutual funds, as investment managers looked to ride the short-term wave.

> ***"To be sure, the drop quietly stung many investment managers who bought into the company because of its outsized effect on relative performance"***

The most visible public supporter of the stock was Bill Ackman, head of Pershing Square Holdings, a New York-based investment fund. Ackman's meteoric rise to prominence occurred as he made escalating bets on companies, including Herbalife, CP Rail and finally, Valeant. His hot streak ended in the fall of 2015, but like most gamblers riding a winning streak, Ackman could not step away from the table while he was ahead. He publically added to his losing bet in November of 2015 and again in February of 2016, both before the final 70%+ collapse.

Intuitively, this does not seem like a huge problem. A very wealthy man won big then lost big with other wealthy people's money… who cares? Unfortunately, the pattern of Pershing Square is one repeated by many fund managers. The manager makes a significant, correct bet, and without proper risk management practices, puts unsuspecting investors at undue financial risk. At one point last year, the Sequoia Fund, a long-venerated US mutual fund, had a 30% position in Valeant, begging the question: what risk management practices were in place to protect investors by limiting the exposure to one holding? Year-to-date, Valeant is down approximately 75% and according to Morningstar, fund redemptions in the Sequoia Fund were in excess of $500 million US in the first quarter alone.

> ***"We are not trying to outsmart the market by forcing ourselves to believe in things that don't fundamentally make sense"***

EGO-FREE INVESTMENT MANAGEMENT

Our former chairman, George Frazer, took the exact opposite approach. His complete lack of ego was probably his most valuable quality as an investment manager. He ensured our firm and our clients could endure the ups and downs of the market. We have risk management rules that limit the size of an individual holding and individual sectors. We are mindful of what can go right and what can go wrong. We are not trying to outsmart the market by forcing ourselves to believe in things that don't fundamentally make sense. George was often quoted as saying, "you only lose money in frauds." He meant this in both the literal and figurative sense. Bre-X was a literal fraud. RIM was a figurative fraud in that the value attributed to the stock for a lengthy period of time was not reflective of the company's long-term earning potential. It appears Valeant is a combination of the two.

THE VALUE OF A SUSTAINABLE COMPANY

Sustainable companies have share prices that go up and down; the magnitude and frequency of the ups and downs is dictated by the business in which they operate. Frauds have share prices that climb astronomically, then collapse and never recover. Most times these companies don't pay a dividend, even at their peak, maybe because they never had the intention of generating a sustainable cash flow stream in the first place. If you buy a sustainable company near its high and it declines, you can average in near its' low and wait for the recovery that is likely to occur and make a positive return. If you buy a fraud near its' high, there is no hope.

Nobody has a 100% success ratio. We have just endured a period where our clients experienced negative returns. Fortunately, we have selected companies that at the very least have the goal of being sustainable entities. The recovery has already begun. ●

Leon Frazer Timeline

NOTABLE CORPORATE SCANDALS

- **1939** Edwin Sutherland invents the term "white collar crime"
- **1949** Tucker Car Corporation shuts down amidst scandal and controversial accusations of stock fraud
- **1950s** Robert Trippet forms Home-Stake-Oil, a presumed tax shelter that swindles $125 million out of wealthy investors
- **1961** GE, Westinghouse and others conspire in electrical cartel to win bids on federal projects
- **1964** Windfall Oils mining scandal rocks the Toronto Stock Exchange, triggering a royal commission investigation and exposing weaknesses in the market regulatory system
- **1970** When mutual fund syndicate Investors Overseas Service implodes, Robert Vesco, an American financier takes over, then siphons $224 million from the company
- **1973** Michael Milken, the Junk Bond King, founds Drexel Burnham Lambert; in 1990 he is indicted for securities fraud and pays a $650 million settlement fee
- **1989** Charles Keating is convicted of fraud in the Lincoln Savings and Loan debacle
- **1995** Nick Leeson loses $1.3 billion through speculative investing, collapsing Barings Bank, the oldest merchant bank in London
- **1997** Bre-X becomes worst mining scandal of all time
- **2001** Enron topples into bankruptcy when shares drop from $90 to $.50 due to an exposed accounting fraud
- **2002** WorldCom files for Chapter 11 after an internal audit report shows the company used fraudulent accounting methods
- **2003** Freddie Mac discloses it has misstated earnings by over $5 billion
- **2005** Tyco CEO Dennis Kozlowski and CFO Mark H. Swartz are found guilty of stealing $600 million from the company
- **2007** Rogue trader Jerome Kerviel trips up the world's financial market when his unauthorized trading results in more than $7 billion in losses
- **2008** Bernard Madoff's elaborate Ponzi scheme becomes biggest financial scandal of all time, robbing investors of $65 billion
- **2008** Lehman Brothers bankruptcy contributes to the erosion of close to $10 trillion in market capitalization from global equity markets
- **2009** R. Allen Stanford orchestrates massive $8 billion fraud by promising high-yielding returns on certificates of deposit
- **2015** Electronics conglomerate Toshiba admits it has overstated its earnings by nearly $2 billion over seven years
- **2016** Investigation of Valeant Pharmaceutical's drug-pricing practices leads to a 90% drop in share price

Source: www.trinity.edu

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