Leon Frazer & Associates
INVESTMENT COUNSEL

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

SEPTEMBER 2016

LEON FRAZER QUARTERLY REVIEW

Equity Market Commentary: Outperformance in the Canadian Market

NORTH AMERICAN EQUITY MARKETS CONTINUED THEIR ASCENT IN THE THIRD QUARTER with both the S&P/TSX Composite Total Return Index and the S&P 500 Total Return Index up 5.5% and 5.4% respectively in Canadian dollars. On a year-to-date basis, the Canadian market is outperforming the US market by 13.6% in Canadian dollars, as US market outperformance begins to reverse.

HINDSIGHT IS 20/20

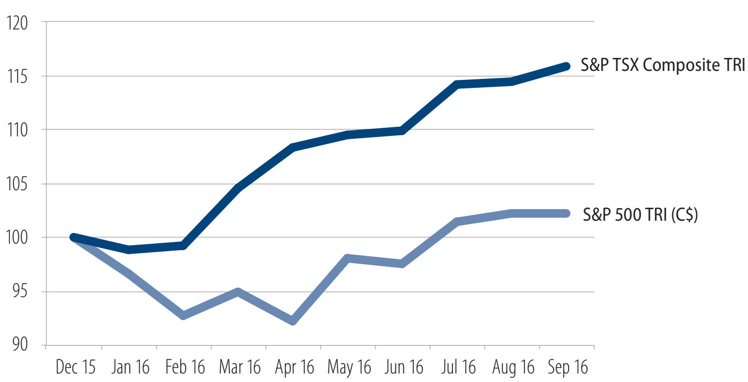
Swings in relative performance between the Canadian and US markets are always easier to recognize in retrospect, but harder to pinpoint in the moment. The US market began its most recent outperformance cycle in early 2011. In hindsight, it is easy to see the Canadian dollar was overextended following the financial crisis in the United States, at the same time US equities had endured over a decade of negative performance and were due for a bounce. In the moment however, there was talk of the US Government defaulting on debts and the Chinese yuan replacing the US dollar as the world's reserve currency. Fear of the US dollar, and thus the US market, was palpable. Typically, the safest time to buy is when fear is high, but it is very hard to enter a burning building when everyone is running the other way. Fast-forward to early 2016 and a similar situation for the Canadian market. Oil had declined to a 10-year low, below $30, and the Canadian market had underperformed the US market by the largest extent ever on a 3-year basis. Again, in retrospect, this was an obvious point to move money into the Canadian market, especially the Oil and Gas sector, but with Goldman Sachs calling for oil to drop to the $10 level, threatening to cripple the Canadian economy, our dollar and especially our housing market, it made our recovery much harder to see.

TIME IN THE MARKET, NOT MARKET TIMING

Academic studies have repeatedly discredited the concept of market timing. If our unprecedented experience of investing in Canadian dividend payers has taught us anything, it is that you never give up the bird in the hand for whatever is lurking in the bush. Heightened currency volatility and ever-declining US dividend yields (due in part to the capital devoted to non-permanent share buybacks) do not entice us for more than small complementary positions in US equities and only where appropriate for our clients. We will never swing money back and forth between

continued on page 2

YTD Performance of North American Equity Markets
Indexed to 100 as at Dec 31,2015



Source: Thomson Reuters

> *"Swings in relative performance between the Canadian and US markets are always easier to recognize in retrospect, but harder to pinpoint in the moment"*

INSIDE THIS ISSUE

Outperformance in the Canadian Market

continued from page 1

"We believe oil prices will continue to steadily grind higher, absent a significant unforeseen drop in demand"

the two markets in hopes of gaining short-term performance, as such short-term focused moves often end up costing clients in the long run.

The biggest reason for the recovery in the Canadian market year-to-date has been the ongoing rise in oil prices. We believed that oil would trade in a choppy fashion over the summer, which turned out to be true. We patiently waited for some seasonal weakness in September to do a final top up and rebalancing of our Energy positions in advance of the OPEC meeting in Algiers during the last week of September. In the immediate aftermath of the Great Recession of 2008, our CIO Doug Kee correctly surmised, "the United States led us into this mess and they will likely lead us out." We look upon the oil price collapse of 2014/15 similarly, in that it was OPEC that got us into this mess with their market share over price strategy and it is likely OPEC co-operation will lead us out. We continue to feel the long-term supply/demand fundamentals are solid for producers of oil and natural gas; a view that looks much more reasonable today than it did 6 months ago.

WE REMAIN POSITIVE ON OUR PORTFOLIO PROSPECTS

Looking ahead, we are expecting an interest rate increase from the US Federal Reserve in December of this year. We remain skeptical of US dollar strength propped up by guidance of interest rate increases that are slow to materialize, combined with the extreme weakness of the British pound in the aftermath of the Brexit decision. We believe oil prices will continue to steadily grind higher, absent a significant unforeseen drop in demand. We remain very positive on the prospects for our portfolio holdings to resume their path of aggregate dividend growth following a year of dividend shrinkage from mid 2015 to mid 2016. Of course, there are always concerns, but it never seems to do any good to worry about temporary setbacks in market values that resolve themselves within a year or two. The first rule of equity investing is to stay invested and to stick to quality companies. Fortunately at these interest rate levels, there is little choice to do otherwise. ●

Fixed Income Commentary

"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"

Fixed income markets were calmer in the third quarter as the Brexit fallout was relatively contained and a beautiful summer on the east coast helped to ensure the usual summer doldrums for the bond market. Things picked up in September as the market began to parse through US Federal Reserve speeches looking for evidence of a September rate hike. We were skeptical the Fed would raise rates before the US election and indeed, rates were left unchanged again at the September meeting. As stated earlier, we expect only one 0.25% increase in administered US interest rates in December of this year, but we do not think this will extend to a prolonged tightening path in 2017.

The JOV Leon Frazer Bond Fund was up 0.75% in the third quarter, outperforming our benchmark (50% FTSE TMX Short-Term Bond Index and 50% FTSE TMX Mid-Term Bond Index) by 0.3%. 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 another 5.5% during Q3, outperforming the S&P/TSX Preferred Share Total Return Index. The preferred equity market continues to bounce back following a volatile winter. When considering that many preferred shares yield more than 4% 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 Q3.

Fixed income markets have continued along their unprecedented path so far in 2016. 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 three decades, fueled by economic growth and interest rate declines following the inflationary mistakes of the 1970s. Recently, the bond market rally has been fueled by the more ambiguous actions of central bank monetary policy. 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 more importantly, when adjusted for inflation. ●

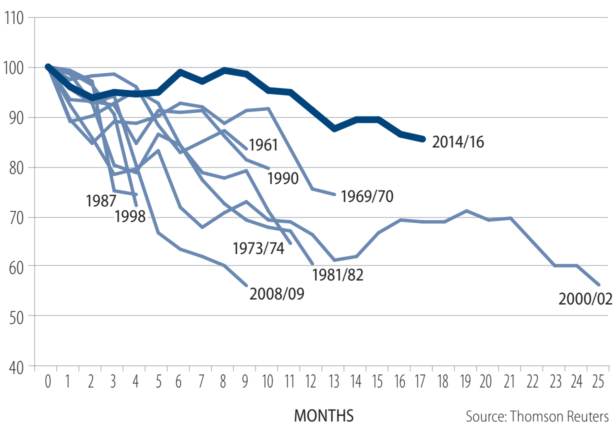
Spotlight: Peak-to-Trough Downturns

With the positive performance of both the market and our Leon Frazer portfolios over the past few months, it appears the second longest peak-to-trough downturn in both the S&P/TSX and Leon Frazer's history is finally over. The following charts illustrate the longest and largest downturns for both the market and our strategy since the early 1950s.

COMPARING DOWNTURNS

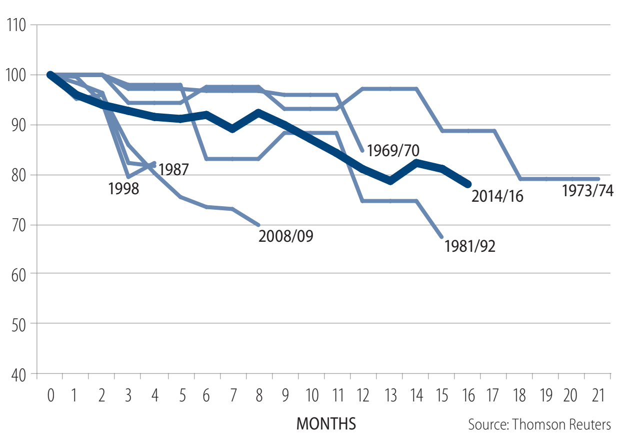
For the S&P/TSX, the 17-month downturn from August 2014 to January 2016 was the second longest, but at -14.3%, the shallowest of the 10 downturns since 1960. The longest downturn followed the collapse of the Technology bubble in 2000–2002 and lasted 25 months. It was the deepest decline, registering a drop of 43.2%, just slightly higher than the 39.2% drop during the financial crisis of 2008 -2009, which only lasted 9 months.

Largest S&P/TSX Peak-to-Trough Downturns Since 1960



For Leon Frazer, the 16-month downturn from August 2014 to December 2015 was also the second longest in our history, but our third deepest at -22.0%. Interestingly, we registered positive returns from 2000–2002 while the market was still reeling from the Technology bubble and have had only 7 downturns of 14% or more in our history, compared with 10 for the S&P/TSX in the same timeframe. The longest downturn in our history was 21 months long, during the brutal 1973–74 market, and our deepest was -32.7% from 1981–1982.

Largest LFA Peak-to-Trough Downturns Since 1960 (Gross)



AN OUTLIER YEAR FOR LEON FRAZER

2015 was an outlier in Leon Frazer's 77-year performance history. The combination of a hot technology market, especially in the US, and a strong US dollar are not normally combined with weak oil prices. Usually when the market is greedy like it was in 2015, dividend-paying stocks underperform, which is why we rarely capture the full upside of the market during such years. However, when the market is chasing riskier sectors with lower dividends, this usually means the economy is doing well and oil demand is growing at above-average rates. The supply driven oil price collapse was large enough in magnitude and the sector has grown to such prominence in the Canadian market that it overwhelmed the positive performance of economically sensitive sectors like Consumer Discretionary and Technology by dragging down not only the Energy sector, but the Banks as well. Basically, we believe last year was an up year disguised as a down year. If the market was up 10% and we were up 7%, it would have been in keeping with our historical record of upside/downside capture, however the oil price downturn created a wave of unsustainable selling of not only Canadian Energy producers, but also Banks and Pipelines.
At the end of 2015 we wrote "the first part of the recovery is always the steepest," and indeed that has played out so far this year. Oil prices have begun to normalize as we expected and Banks and Pipeline shares are making new highs in Leon Frazer portfolios. All of our 2015 losses were erased by mid July and we are quickly approaching our all time high set in August 2014.

COMMITTED TO OUR TIME-TESTED STRATEGY

Unfortunately, the combination of a headline-driven news cycle and computerized trading has seemingly exacerbated market volatility and with it, client anxiety. Markets have always been volatile, but coverage today is far more intense and immediate. Clients are increasingly reliant on equity portfolios, not salaries, pension plans or fixed income solutions to pay their bills and fund their lifestyles. The Canadian market is home to some of the most consistent, highest paying dividend stocks anywhere in the world, all in a currency that matches the majority of our clients' liabilities. That is why we remain so committed to our strategy, even when things look as bleak as they did this past winter.

STAYING THE COURSE

We will continue to execute a Canadian dividend strategy on behalf of our clients. Our returns have outperformed both the TSX and the S&P 500 on a total return basis in Canadian dollars for all periods exceeding 20 years, with higher income and lower volatility. We stay the course because we have statistical evidence of 77 years of steadily protecting and growing our client's wealth. Quality companies that provide essential goods and services that Canadians use every day never stay out of favour for long and provide significant income, regardless of how they are valued in the moment. ●

Leon Frazer Timeline

KEY MOMENTS IN BASEBALL

- **1939** Lou Gehrig delivers his *Luckiest Man on the Face of the Earth* speech
- **1941** Joe DiMaggio hits in 56 straight games
- **1947** Jackie Robinson breaks the colour barrier when he debuts with the Brooklyn Dodgers
- **1956** Don Larsen pitches perfect game in World Series
- **1956** Mickey Mantle wins Triple Crown
- **1961** Roger Maris hits 61 homeruns in season
- **1968** MLB lowers pitcher's mound
- **1974** Hank Aaron surpasses Babe Ruth's record with 715 homeruns
- **1977** Reggie Jackson hits three home runs in one World Series game
- **1979** Nolan Ryan becomes first million dollar player
- **1986** Roger Clemens strikes out 20 Mariners to establish strikeout record
- **1989** Pete Rose banned from baseball for gambling
- **1993** Joe Carter hits a walk off home run to win World Series
- **1994** MLB goes on strike
- **1995** Cal Ripken passes Lou Gehrig's record of 2,130 consecutive games
- **2004** Red Sox break the curse against the Cardinals
- **2005** Jose Canseco's book, *Juiced*, exposes steroid scandal
- **2007** Barry Bonds hits 756th career home run
- **2010** Yankee Stadium demolished
- **2016** Dodgers announcer Vin Scully retires after 67 years

Source: bleacherreport.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