47 Colborne Street, Suite 300
Toronto, Ontario, Canada M5E 1P8
T 416.482.2004 • 888.482.2007 F 416.482.0007
www.avenueinvestment.com

FOURTH QUARTER 2013- MARKET COMMENTARY

HIGHLIGHTS

- **Reflection on Avenue's first 10 years**
- **Bond yields now at a more rational level**
- **Equity returns focused on reducing risk**
- **A cautious approach for 2014**
- **NBCN custody update**

Avenue Investment Management has now been looking after client money for 10 years. In this quarter's letter we will revisit our original purpose and discuss our present challenges. This will be followed by our usual discussion of the current investment climate and how we are positioning our investments for 2014.

Reflection on Avenue's first 10 years

Avenue was started with two simple ideas that we felt were not being properly addressed by the investment industry. First, we believed that all Avenue clients should be treated as well as we would like to be treated ourselves. Second, we decided that Avenue's investment strategy was to capture the long term compounding from the stock market, which has historically been approximately 8%, but try to accomplish this with as little risk as possible.

The bond portfolio's strategy is to enhance a traditional government bond portfolio with the higher rate of return offered by meaningful exposure to Canadian Corporate Bonds for our clients who need certainty of income.

Recently, Avenue's partners spent a day off site reviewing the last ten years and determining which factors have had the biggest impact on our success. We concluded that Avenue has reached this sound position from clearly executing the above two simple ideas. It has been a very hands-on process since we take responsibility for doing all the work ourselves. As the number of our clients has grown and we have added a few people to the team, our challenge is to maintain that same level of care and attention to detail. This is a human industry and errors can happen, but our commitment is to directly address any and all problems as soon as they come up as transparently as possible.

The tangible ways we commit to being client friendly seem to distill down to three factors. We can legitimately claim to care about how our clients' money is invested because 100% of our own money is invested the same way in Avenue's portfolios. We also cut our management fee in half for the following year when equity returns are negative. As well, Avenue still has just one phone number and all questions and requests for assistance will be responded to promptly. These three factors all seem quite simple but it is amazing how our competitors are not accountable in the same way.

We continue to enhance our client services**.** Over the last few years we have refined our ability to maintain an individual or family financial plan based on our own software that assesses overall assets and liability risk for any client that is interested.

Our investment strategy is slightly more novel. We ask the question: Can we capture the long term stock market compounding of 8% but do it with as little risk as possible? We try to do this by investing in a diversified portfolio of high quality companies where we look for profitability and stability. The focus of Avenue's research is to find investments where we can limit losses or, to use a sports analogy, win by not losing. We are very happy with the results.

Avenue's average equity portfolio has compounded 7.2%, even accounting for 2008, but we have done this with 44% less volatility than the TSX stock market index. We will go into more detail in this quarter's Case Study.

Bond yields now at a more rational level

This is a great lead-in for where we see risks and opportunities for the year ahead. For Avenue's Bond portfolio, 2013 was a year where the effort was put into not losing money.

We now believe interest rates are at a more appropriate level. If we use the US 10 year treasury bond as an indicator of rates in general, the yield has now risen to just around 3%. What has changed is that US inflation has fallen to just above 1%. So the real yield after inflation is about 1.7% which is exactly the historical average.

For all the reasons we have discussed over the last few years, we just don't see how inflation can dramatically increase in the near to mid-term.

Avenue Composites 2013

Avenue Total Return Equity Composite Portfolio	**10.6%**
Avenue Bond Composite Portfolio	**1.9%**

Indices 2013

Canadian Consumer Price Index	**0.9%**
DEX Canadian Bond Index	**-1.2%**
S&P/TSX Composite Index	**9.6%**
S&P 500 Composite Index (CAD$)	**38.7%**

Note: 2013 percentage change returns, pre-audited, net of fees. Individual performance may differ due to size and timing of investment.

In the Avenue Bond Portfolio we have bought more mid-term bonds to increase the overall term to maturity of the portfolio, from very short to a more neutral 7 years. We are also still getting paid a reasonable rate of return above government bonds to own Canadian investment grade corporate debt. Higher yielding non-investment grade bonds are harder to find. If we can't find anything that meets our return objective, we will wait until such an opportunity presents itself. We feel a conservative return expectation for the bond portfolio is now 3 to 3.5%.

Equity returns focused on reducing risk

The U.S. equity market did very well in 2013 in contrast to the resource heavy Canadian market. Profitability did not actually change much for North American consumer and industrial companies. However, investors came to the conclusion that there was no alternative to these types of investments and prices of stocks were driven up. We would argue that if we didn't love these businesses a couple of years ago, why would be buy them now but at a higher stock price.

As part of our core investment strategy, we would like to emphasize that we have owned many of our companies for most of the last 10 years. These are the same investments that did not fall dramatically in 2008 so there was not that same springing back effect in their stock market prices. We have participated in the overall consistent compounding of their profitability. We are careful to limit dramatic downside risk, but that does limit dramatic upside potential.

We have investments like Timbercreek Mortgage Investment Corp., BTB REIT and Yellow Media Bonds where the cash flow contribution to the Avenue Equity Portfolio was going to be 7-8% no matter what happened to the stock market. Wherever we can, we are locking in a consistent return and limiting risk.

We actually have significant foreign exposure compared to past years. Direct investment in foreign companies is at 18.2%. It is also important to monitor indirect foreign exposure. As an example, TD Bank and Royal Bank have about 50% of their respective businesses in the US. This is a much more grey calculation, but our total exposure to businesses and assets outside of Canada is closer to 30%.

While resources have done poorly for the last three years, we have maintained our exposure because we believe we own good companies. As long as we are limiting our losses, we need to be building positions in high quality income streams which are being ignored by other investors. For example, we have done very well in Tourmaline in what has been a terrible pricing environment for natural gas producers.

A cautious approach for 2014

A very unusual development in the last few weeks is that one major indicator of investor sentiment has now fallen to 14% bearish. Neutral and bullish sentiment are equally split at 43%. How we interpret this is that investors don't necessarily think the market is going to continue racing up, but that almost no one is left believing that the market can go down.

Traditionally, when most investors believe nothing can go wrong, market shocks are more likely to happen. We have been building conservatism into your portfolio in the form of cash and making sure the valuations of our investments are not stretched. In a down market we try to stay fully invested, but now that we have had a significant up market we will be more cautious going into 2014.

NBCN custody update

We have one housekeeping note with regards to NBCN which is the custodian of all your Avenue accounts. NBCN has recently bought TD Bank's sizeable custody business. We believe the resulting bigger custodian will make significant investments in new technology from which we will all benefit over time.

Case Study on Equity Portfolio Volatility:

We have written about Avenue's theory regarding equity portfolio volatility, or risk, over the last 10 years in several case studies. Now that we have completed our first decade, we are happy to share with you that the results were much better than what we had hoped for.

Our stated goal was to capture the long term stock market compounding of 8% but do it with as little risk as possible. We had hoped that we could reduce volatility by as much as 25 to 30% and still meet our return targets. We are off slightly on our return target of 8% as the average Avenue portfolio has compounded at 7.2% over the last 10 years. Nevertheless, we managed this in a decade where we experienced the worst stock market crash since the 1930s.

Our constant focus on risk reduction resulted in the volatility of Avenue's equity portfolio coming in roughly 44% lower than the TSX Canadian stock market index. Volatility is calculated by comparing the amounts that Avenue's portfolio and the TSX index swing up or down monthly to their long term average returns. This is the standard way that the investment industry measures risk.

We accomplished this low volatility by a commitment to invest in high quality businesses and other consistent income streams. If our companies are established and profitable, with reasonable levels of debt, they usually have a more predictable stock price.

The Avenue Equity Portfolio is also slightly more diversified across uncorrelated asset classes than the major Canadian and US indexes. The TSX index has a high concentration of resource stocks and the US S&P500 index is predominantly a mix of financial and consumer/industrial businesses. Avenue's portfolio has a much more balanced exposure to the securities in both those indexes and also includes meaningful positions in utility and telecom businesses, real estate and high yielding bonds.

Our investment process continues to be driven by searching for securities where we can lock in an 8% return with limited downside. If we find one, we grab it. This sounds simple enough but it is not that easy in practice. Today's very low interest rate environment makes it much more difficult to find quality securities and means we must consistently maintain our disciplined approach.

Avenue Investment Management
Getting there together