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# FIRST QUARTER 2014 - MARKET COMMENTARY

We have made some major incremental changes to diversify the portfolio this last quarter. The main reason for diversification is to further lower risk by broadening our range of investments. We will start this letter by giving details as to why the changes were necessary, followed by what the changes are.

In our last letter we focused on Avenue's 10 year milestone of money management while achieving a performance we are satisfied with and most importantly accomplishing this with less risk. To restate our investment strategy we ask the question: Can we build a portfolio of investments that target an 8% rate of return but do it with as little risk as possible? If we can do this, we should be able to approximately double our original investments in 10 years.

Investing is as much an art form as it is number crunching. There are quite a few variables that can throw us off course over a time span like 10 years. Therefore, it is important to lower risk because as we try to minimize events we have no control over, we subsequently increase the chance of us hitting our return target. True, we did not quite double our original investment in 10 years; it took 10 years and two months. When we think about hitting a target 10 years in the future, being off by just two months is in some ways freakishly accurate given all we went through.

The goal for the next 10 years is to again double our portfolio and continue to do it with as little risk as possible. Avenue's discussion which led to the portfolio changes had two main themes. First, the rate of decline of today's low interest rate environment is not likely to be repeated in the next five to ten years. Second, Canadian investors have a bias towards the banking and

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energy sectors. We feel we can reduce our exposure to these two, take this money and broaden our investments in other sectors of the economy, reducing sector-specific risk.

To talk about this in more detail, interest rates have had this incredible move to today's low level. Yes interest rates could stay low, but how likely is it that they will make another similar move lower from here as they did in the last decade? The chance of this happening is important to acknowledge as a way to address those sectors, like real estate and utilities, which experienced the most direct impact with the move to low rates. As interest rates went lower, the prices of property and tangible assets like pipelines went dramatically up.

We will maintain some exposure to these types of investments. However, where we would have had 10% to 12% invested in real estate and a similar amount invested in utilities, we have brought our Avenue neutral weight down to 7% and 8% respectively. Also, we continue to refine our existing investments. Yes, real estate is expensive. However, we have focused on apartments in Alberta where we feel rents can still go up. In utilities, we sold Keyera due to its high valuations and replaced it with Boralex which has almost half the valuation and the company's cash flow continues to grow.

The harder decision was to lower our normal weighting in banking and energy. These are major parts of the economy but they are an even more disproportionately large part of the Canadian TSX Index. Avenue's portfolio has always had lower weightings than the index but not enough to free up significant room for other diversifying investments. Financial Services now has an Avenue normal weight of 17.5% and energy is 11%. Currently we are overweight in these target neutral weights but that is because we have a view that these sectors will continue to do well. Then as individual stocks hit their targets, they can be sold and the sector weighting will drop to the level where we become neutral again.

We usually do not get this technical in discussing the equity portfolio but in this case we felt the background story was important. In summary, Avenue's investments in real estate, utilities, banking and energy have been reduced which frees up significant room for investments in healthcare, technology, consumer services and industrial businesses. We feel that a broader base of investments will diversify and subsequently reduce the risk that a shock to interest rates or oil would have previously caused to the portfolio.

Avenue is now diversified by sector so a further margin of safety is built into our investment discipline. And we still ask those two important questions: Is this a good business and can I buy it at a good valuation? The handful of businesses that have met our requirements are Deer & Co. in industrial, Qualcomm in telecom, Target in consumer, Amgen in healthcare and Sirius XM Canada in broadcasting.

So far in this Comment we have not mentioned the overall state of the stock market. At the moment, we continue to build caution into the portfolio. In this quarter's case study we discuss the relationship of corporate profits to labour costs and how the future might negatively impact the stock market.

**A Case Study on Profit Margins and Labour Costs:**

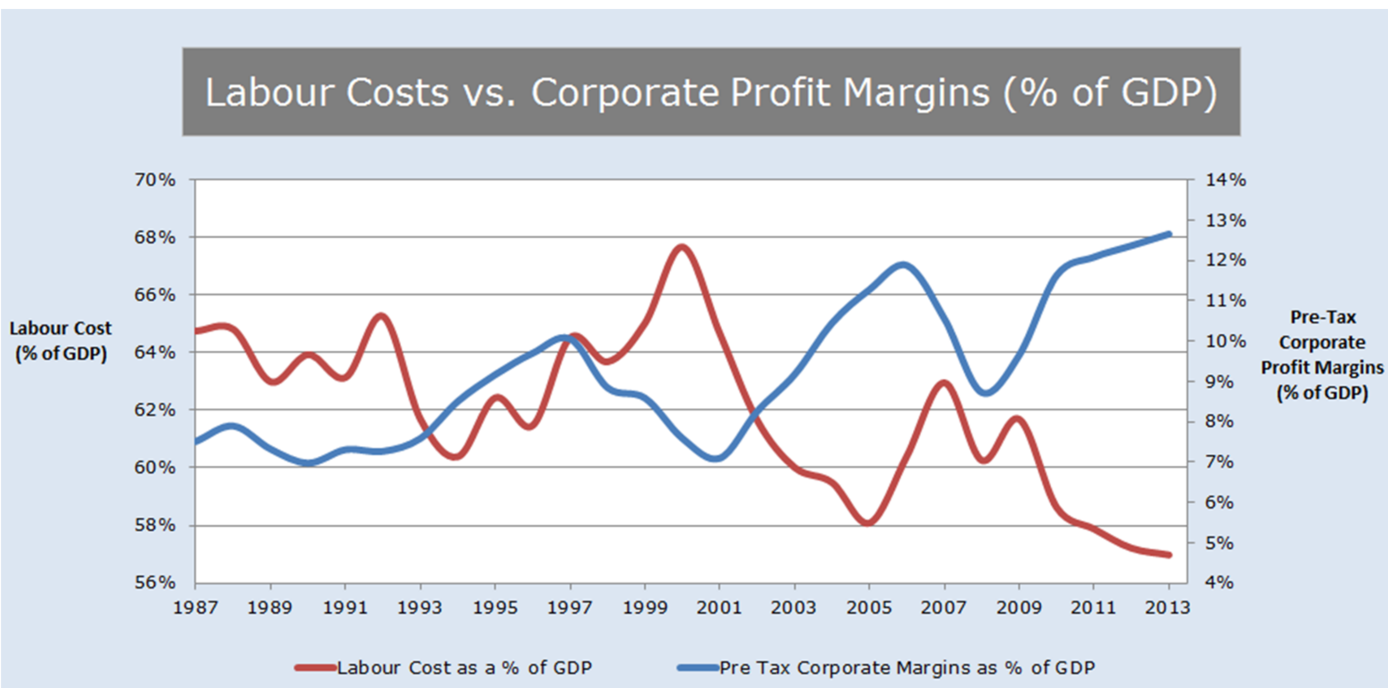
Avenue's Equity Portfolio is up 95% in the last 5 years. The stock market is often described as having peaks and troughs. With an equity upswing of 95%, it would seem that we are closer to a stock market peak than a trough.

Even though we appear closer to a peak, this does not mean that we need to sell all our holdings and sit on our cash. There have been periods in history where the stock market goes from being expensive to very expensive and any type of correction could be years away.

We simply use this period as a time to filter our investments. When the portfolio was down in 2009 and companies we liked were at cheap valuations, we made a strategy shift to be aggressive. Now, we need to view investments with more restraint.

When we look for actual confirmation of why caution is needed, we think the relationship of corporate profits to labour costs tells us a great deal. The stock market rose to this current high because corporate profits are strong. Since interest rates are low, investors have to pay up for those profits. Therefore, corporate profits should be one of the key variables used to determine the future direction of the stock market.

Recently, corporate profits have been strong because labour has taken less of the economic pie. This is a pretty simple and clear relationship we can see from the chart. However, we can start to anticipate that as unemployment comes down and economic recovery continues on a 3% pace in 2014, labour will begin to extract pricing power. This is an economist's way to say labour costs are going up and corporate profits are going down.



For our investment strategy, it is important to acknowledge the evolving environment and position ourselves where we will be least affected by higher labour costs. This is all part of the process of minimizing risks we can contain while still compounding at our target rate.  As an example in the portfolio, Timbercreek, which lends short-term financing to the real estate industry, would be affected by a rise in interest rates but virtually unaffected by a rise in overall North American labour costs.

**Avenue Investment Management**
*Getting there together*