A Case Study on Profit Margins and Labour Costs:

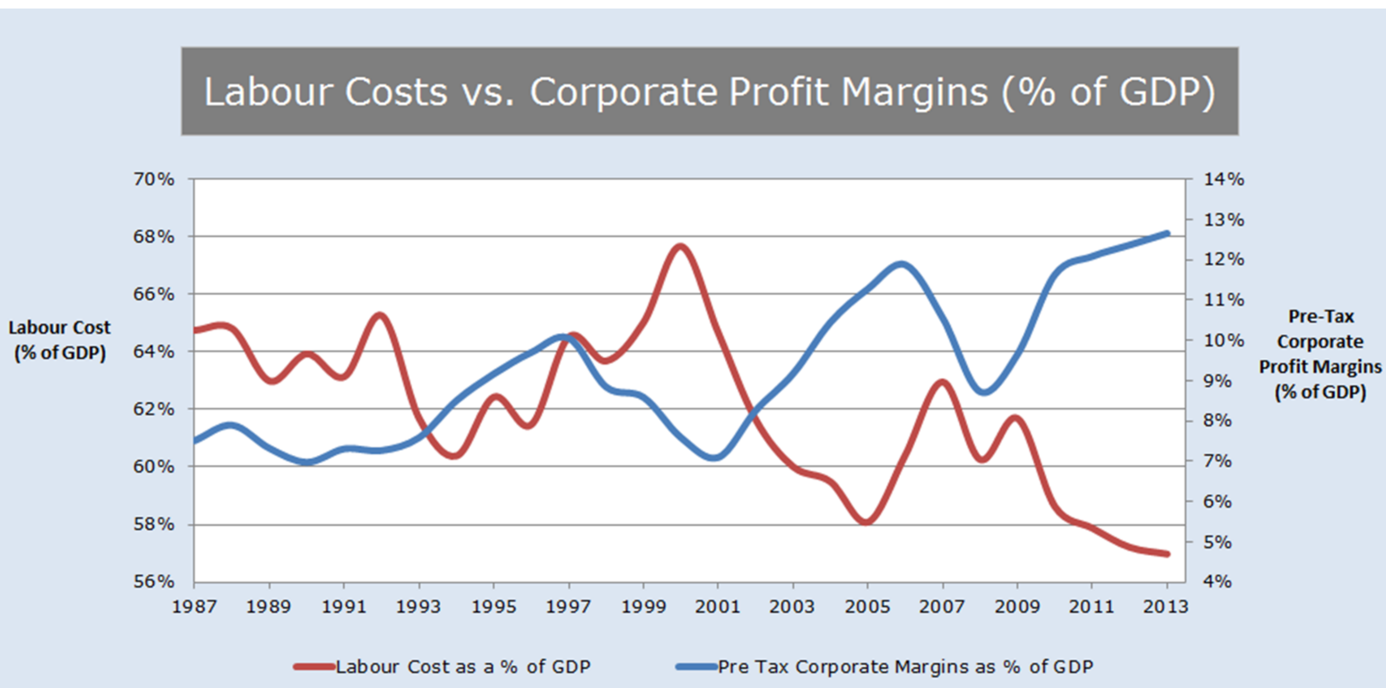
Avenue's Equity Portfolio is up 95% in the last 5 years. The stock market is often described as having peaks and troughs. With an equity upswing of 95%, it would seem that we are closer to a stock market peak than a trough.

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 mindset as a starting point when analyzing our investments. When the portfolio was down in 2009 and companies we liked were at cheap valuations, we made a mental shift to be aggressive. Now, we feel 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.