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In this quarter's letter, we would like to review Avenue's bond portfolio strategy and performance. We will then give an update on why Avenue's equity strategy is well suited to approaching today's investment uncertainties. We will conclude with our view on current stock market valuation, given this has been the focus of many client questions over the last few weeks.

Last quarter's Case Study gave an updated summary of Avenue's bond portfolio strategy. We thought this was timely given the current concern that interest rates might start to rise. The point of the Case Study was to explain that not all bond strategies are the same.

We discussed that the majority of Avenue's bond portfolio is made up of medium term Canadian corporate bonds. Avenue's bond portfolio has a different level of risk compared to a government bond portfolio or to a bond strategy based on trading short term moves in interest rates. Often very different strategies will randomly have the same return so it is hard to distinguish why they might be different or what risks are actually being taken.

Looking at the current one year performance truly reveals how different Avenue's bond strategy is compared to investing in the bond index. Here we will use the Canadian bond index as a proxy for what many investors simply refer to as 'the bond market'. For the last 12 months, long term interest rates have experienced a few dramatic swings but the net result is that the Canadian bond index had a return of 1.5%. This compares to Avenue's return of 4.8% from a portfolio of predominantly Canadian corporate bonds. The extra return was achieved by taking on credit risk by lending money to corporations for a short to medium period of time. The Canadian bond index has a higher proportion of government bonds with longer maturities, which is a riskier portfolio at these low interest rates.

At Avenue, we believe our bond strategy has a universal or all-weather appeal to it. If interest rates stay at these levels, we will continue to benefit from the higher income generated from

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investing in corporate bonds. If interest rates rise, the shorter term to maturity of the portfolio means as our bond investments mature sooner, this money can be reinvested at the higher rates.

We also believe that Avenue's equity strategy has a similar universal appeal to it. However, we usually describe it as an internal insurance policy. There are two parts to our policy: the first is our focus on investments that generate consistent cash and the second is a 20% allocation to higher yielding securities which are usually bonds.

Before we outline the benefits of our insurance policy, we need to always remember why we are investing in the first place. Compounding in the stock market as a long-term investor requires staying invested, usually over decades. So, the decision to sell all stocks and sit on the side line is actually a big deal. The irony is that although it seems safer to not be invested, this decision comes with a great cost of lost opportunities. If you sell everything and sit on the sidelines, the market 'has to go down' within a relatively short time period of months, because as a long-term investor you know you need to be buying back in at some point. Another approach, trading on short term swings in the market, is the definition of what is called speculating, and again the long-term speculator must be consistently right over and over again.

Yes, the stock market can have dramatic short term declines, usually when most people least expect it, as we recently experienced in 2008. Therefore, at Avenue we believe the money you need to live on in the short term should not be in the stock market. This allows us to take a ten-year view when making an investment in individual stocks with money that is available for the long term.

Let us look at Avenue's equity strategy and why consistent cash flow and bonds are important given three stock market scenarios. First, if the stock market shoots up in the short to medium term, Avenue's portfolio of more consistent cash-generating investment will likely underperform the overall market. However, we will hopefully still get a decent return for the level of risk taken.

Second, there is always a legitimate risk that the stock market will stall for a long period of time, possibly even a decade. Avenue's portfolio of income generating businesses will be kicking out money that can be reinvested over the period that the market is flat. Again, this highlights the important part of the strategy that the money cannot sit on the sidelines. The cash that is coming into the portfolio needs to be constantly reinvested into the stock that has the highest income generation at that point in time. So even though the overall stock market is flat, Avenue's equity portfolio should be able to have a positive return.

The third scenario is the one that we all worry about the most, which is a significant and sustained short to medium term decline. In this situation, guessing that the market was going to go down and being on the sideline is obviously the best place to be. However, as stated previously, one really must be accurate with the timing and again this implies an expectation of perfectly timing an event that most people don't expect to happen. You can see the paradox.

The second part of Avenue's internal insurance policy is very important if we experience a market correction. The equity portfolio's 20% bond and cash holdings can be used to buy stocks that are now at much lower prices. Also, there is constant cash coming into the portfolio by way of dividends. So over 12 to 18 months, we should be able to reinvest up to 25% of the portfolio to take advantage of high quality investments that are selling at much lower prices. If lower prices or a bear market is sustained, we should be able to fully reinvest a third of the portfolio over two to three years. This strategy has an incredible advantage when compared to a much less flexible, fully invested equity strategy which owns primarily growth stocks that do not pay dividends.

Avenue's equity portfolio's stated goal continues to be 'to double the portfolio in 10 years with as little risk as possible'. This goal requires a compound rate of return of a bit more than 7% annually. But as you can see from the previous three scenarios, creating consistent returns in the stock market is always relative to a stock market that is anything but stable. Taking a conservative approach works well over time.

Finally, we would like to discuss our view on the current stock market valuation, with stocks having risen 10% after the election of Donald Trump. Here we will use the S&P500 market index as a much better indicator of the broad market compared to the Canadian TSX Index. Currently the S&P 500 trades at 18 times earnings. This is only slightly more expensive than the historical price earnings average for the S&P500 which is 17 times. We believe the stock market should be more expensive than the historical multiple because companies are able to borrow money at such low interest rates.

The stock market is now at a fair valuation and there is a risk that it can go significantly higher given that a multiple of 20 times earnings is not unreasonable. The risk on the down side is that earnings do not materialize as costs increase and interest rates rise. That profit margins will contract is always a concern but for the time being we view this scenario as less likely. We will be monitoring our individual companies closely and more likely we will lighten securities on a case by case basis if valuations become too expensive or margins become less predictable.