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SECOND QUARTER 2014 - MARKET COMMENTARY

North American growth and inflation continue at an orderly and reasonably predictable pace. In this environment interest rates have remained low and stable resulting in a further upward revaluation of the stock market. While Avenue Investment wishes to continue to participate in the compounding of the stock market, we are doing so by subtly changing what we own to protect our downside given the uncertain nature of investing.

The Canadian economy continues to grow at 2% and inflation expectation remains in the 2% range. This has been the status quo for the last four years but this is not the historic norm. The economy usually surges then pulls back as the business cycle expands and contracts. This overall lack of economic volatility is producing new investor behavior where stock prices are bid up because, at the moment, returns are more predictable.

When we look at the bond market we believe interest rates should be slightly higher given inflation expectations. The problem is that a subdued economic growth of 2%, combined with large government debts, have caused the Bank of Canada to keep short term interest rates low for now, and likely for the foreseeable future. In addition, large institutional investors, like pension plans and endowments, remain risk averse and are obliged to own bonds regardless of the low level.

Bond investor expectation at the beginning of the year called for rising yields throughout 2014. This higher yield has not occurred and the Avenue bond portfolio has done well so far this year. We still believe interest rates should increase over the next few years but the pace of this revaluation will be gradual. The structure of Avenue’s bond portfolio is set up to reinvest into higher rates as opportunities are presented. Also, the majority of the bonds remain invested in Canadian corporations where we think we can capture that incremental return above government bonds. Our expectations are that the bond portfolio will return about 4.0% on an annualized basis, in spite of today’s low interest rates.

Low and stable interest rates drive up stock prices as investors seek out yield and capital gains to replace interest income. At the risk of being repetitive, we wish to restate how the S&P 500 index in the US gets to 2,000. Currently, earnings estimates for 2014 are $110 for the S&P 500 index. We use a historically higher stock market multiple of 18, because interest rates are low. Therefore, the price-to-earnings ratio is 18 x 110 =1,980 or close enough to 2,000 on the index.

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The S&P 500 index has now reached the valuation level that we predicted. At the moment, this is an expensive stock market that we fear might become more expensive. (Doing this simple mathematical exercise for the Canadian TSX index is more complicated because all the resource company earnings are so erratic).

As investors, we have a predicament. We know we need to stay invested but we also know the overall market is not cheap. However, there is a positive case for investing. Record high corporate profitability is generating high levels of cash. Because the economy is growing slowly, there is no great rush to reinvest this cash and absolutely no need to borrow more money from the banks, even at these low rates. But cash sitting on a corporate balance sheet will not stay there for long. Either a company gets bought for the cash or management deems they had better do an acquisition and spend their money before they get acquired. Corporate merger activity has the result of driving overall stock prices even higher as bidding heats up.

The other interesting piece of information is that retail investors still have a lot of money on the sidelines. A recent research report estimated that retail investors in both Europe and North America have 35% to 40% of their holdings in cash. The presumption is that as stocks continue to rise, retail investors will capitulate and come back to investing in stocks and drive prices higher still.

It is hard to find an argument why stocks would fall any time soon. However, therein lies the problem of complacency. Avenue is building in a cushion should stocks fall dramatically from some unexpected external shock. For example, the New York stock exchange has record margin debt where, if the price trend reverses, there could be waves of forced selling.

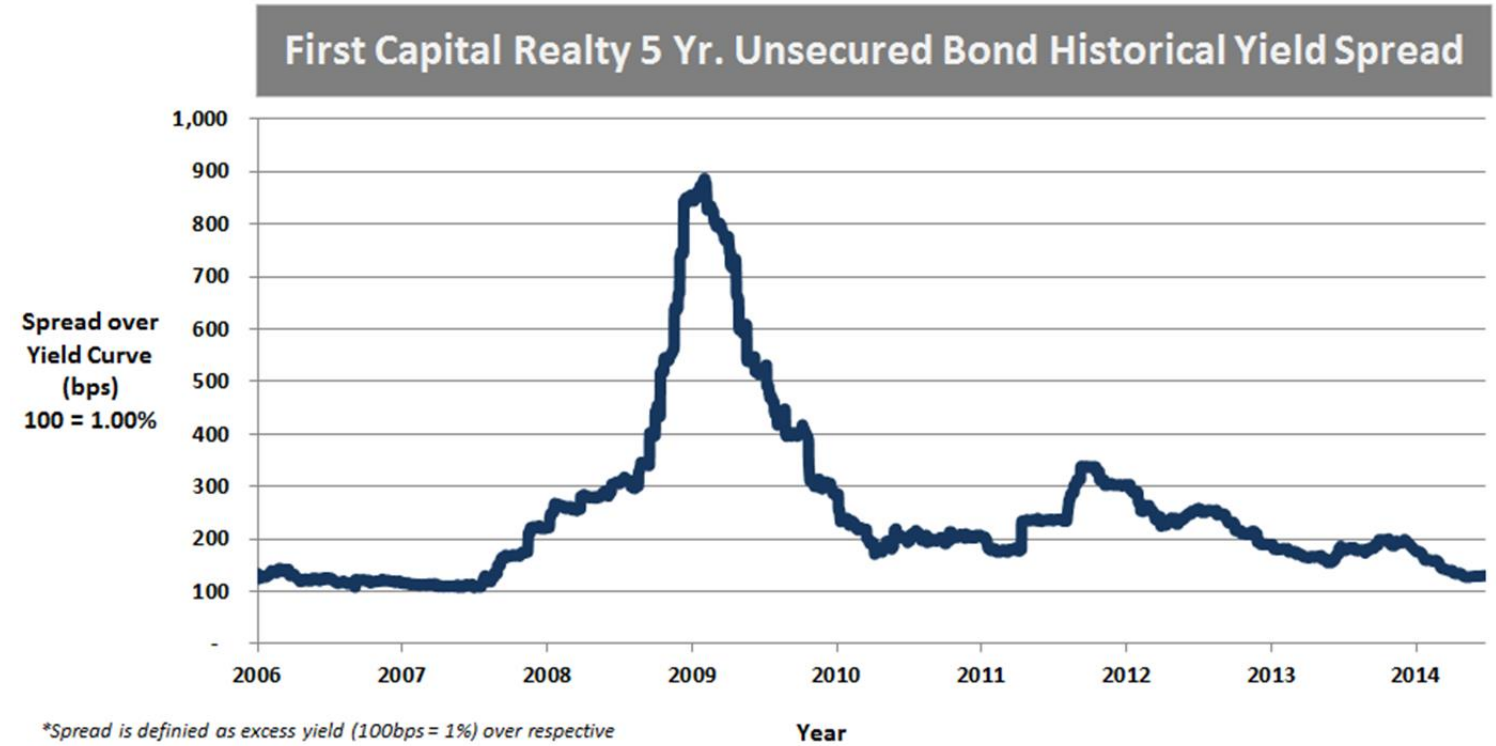
To position ourselves for this environment, we are actively adjusting Avenue’s equity portfolio so we can participate in the stock market but protect ourselves from overvaluation and have the flexibility to take advantage of any market disruptions. Avenue’s equity portfolio now has about 11% cash holdings.

We see the most overvaluation in real estate and utilities, and we have lowered our weightings to 8.5% and 6% respectively. We have also incrementally diversified the portfolio with the additions to industrial, consumer, health care and consumer stocks. Most of these adjustments were done in the first quarter of the year. The benefit is that we have invested in a more diversified mix of businesses where their individual cycles will offset each other but where we can capture the long term income streams.

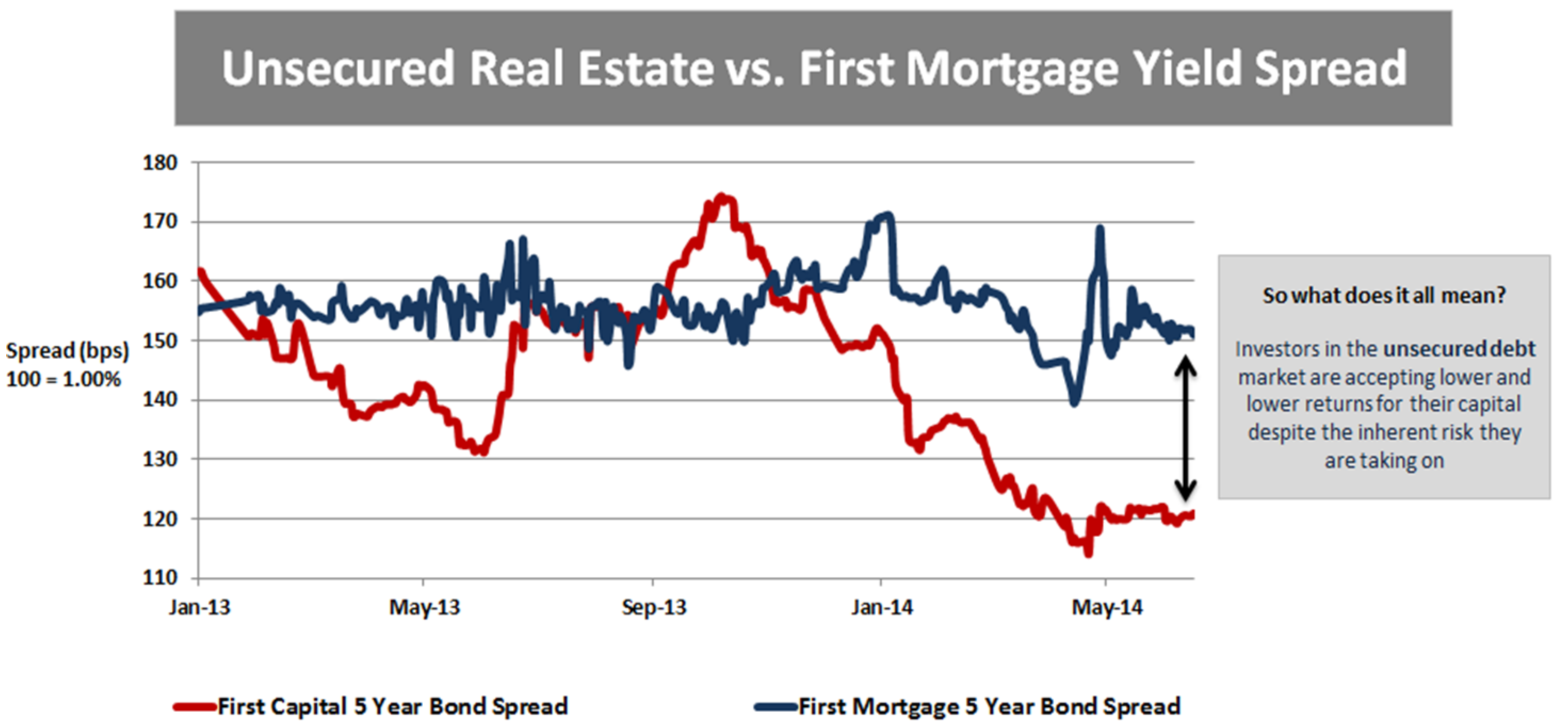
However, the adjustments that make the biggest impact are selling outright or reducing exposure to expensive stocks and replacing these positions with lower valuation investments. A good example in Q1 was the sale of the infrastructure company Keyera Corp. which trades at 14 times cash flow and adding Boralex Inc. trading at 6 times cash flow. As well, we sold the copper company First Quantum Minerals Ltd. in Q1 which trades at 10 times cash flow and replaced it this quarter with the copper company Nevsun Resources Ltd. which trades at 4 times cash flow. The lower valuations support the stock prices if confidence in the overall stock market were to turn negative.

In summary, we feel our investments will capture the rate of return we are looking for but we have built in flexibility to take advantage of opportunities as they are presented.

Case Study: The 10 year Real Estate Bond Rally & its Implications



**Spread is definied as excess yield (100bps = 1%) over respective Government of Canada Bond*



**Spread is definied as excess yield (100bps = 1%) over respective Government of Canada Benchmark Bond*

**Defined as a Bond secured by a mortgage with first call on the Assets. Typically they are backed by either real estate or hard assets.*

For a considerable amount of time Avenue has publicly and privately pronounced that unsecured real estate bonds were mispriced relative to the risk an investor was taking. We have always seen value and hence our bond portfolio has always been heavily invested in this sector. From 2004 until 2013, 5 year maturity real estate bonds yielded roughly 1.5-2.5% more than Government of Canada bonds (GOCs).

The credit agencies have always rated the sector's debt as BBB or BBB low, which is considered a low quality investment grade bond. The credit agencies had a general feeling that the ratings were appropriate due to Canada's real estate problems in the early 1990s, e.g. the Bramalea Ltd. and Olympia and York bankruptcies.

Avenue has always believed that real estate issuers were being mispriced by the market and the credit agencies. Several factors led to our strong opinion over the past decade.

Real estate issuers benefited from important structural changes that positively affected the sector. Most importantly, the market benefited from low real interest rates. This dynamic was created due to Canada's relatively strong fundamentals on its budget deficits (and surpluses) when compared against the rest of the world. Canada's low debt/GDP, roughly 35%, over this 10 year time period allowed real interest rates to stay very low which directly benefited real estate assets.

Secondly, through this period real estate companies that issue bonds became more conservative. Not only were there stronger bond covenants put in place for the investor since the 1990s but the sector has lived with lower leverage and payout ratios that has helped the balance sheet become more conservative and as a result bond holders have been in a stronger credit quality position.

To put this in perspective, real estate bond yields were priced at 3% over GOCs. Over the past decade, the sector's spreads have narrowed to only 1.2% over GOCs. We believe the sector is now fully valued and it will be hard to justify overexposure to the sector.

A Shift in the Unsecured/Secured Market

An interesting dynamic has occurred recently with the relationship of real estate bonds and 1st mortgage bonds. Historically, 1st mortgage bonds have always traded around 1.5% above GOCs. Real Estate bonds have always traded above 1st mortgage bonds, usually 0.5 – 0.75% over 1st Mortgage bonds. This makes sense since being a holder of a 1st mortgage bond would place the investor higher on the capital structure than unsecured real estate issuers and therefore they would get paid first on any bankruptcy.

As the prior chart shows, an anomaly has occurred. Unsecured bond spreads are now below 1st mortgage bonds. Real Estate bonds are now at 1.2% over GOC and 1st Mortgage bonds are still at 1.5% over GOCs. This gives us an opportunity, because of the yield, to invest in 1st mortgage bonds. The problem is that it is very difficult to find this type of bond due to inconsistent issuing and supply.

As a substitute, mortgage investment corps (MICs) are widely available and trade on the public markets. They are similar to1st mortgage bonds which concentrate on conservative loan to value calculations.

Just to be clear, a MIC is a more risky investment relative to a 1st mortgage bond due to its equity nature; but you are being compensated for that risk. The yield on MICs are roughly 6.5%. On a risk adjusted basis we believe these investments are inexpensive. Both Avenue portfolios own Timbercreek Mortgage. We will be looking for other investments in this sector in order to increase our exposure, instead of buying real estate bonds.

Avenue Investment Management
Getting there together

Bought: Nevsun Resources

With global growth returning and China's economy not slowing down, we would like to have some exposure to base metal mining. Nevsun has a 4% dividend yield and trades at 4 times cash flow. The management has a track record of successfully growing a mining company.

Sold: Longview Oil Corporation

The company looks to be acquired by Surge Energy in an all-stock deal. We do not wish to own Surge Energy on a go forward basis. We believe the new company is aggressive when accounting for reserves.

Sold: YPG 9.25% 2018

The bond is now fully valued at of $106.30 (our exit price) the inherent risk to the bond is "call risk". Yellow Media can call the bond early and redeem it at 105.00. Coupled with the mandatory semi-annual retirement payments at 100, makes this bond expensive. We have now completed our exit strategy for Yellow Pages restructuring. We were satisfied with the results.

Buy Sirius XM 5.625% 2021

Sirius XM's capital structure is more conservative than it used to be when it was two separate companies. We believe the bond is "cheap" and its underlying credit quality is better than its given credit rating. The company is considered under levered. Its consistent free cash flow, limited acquisition strategy and low future capital expenditures will give the bond stability and possible spread compression.

Sold: Aecon 7% 2014

Convertible bond was maturing in September of this year and was priced expensively at 104. Unless Aecon's stock trades above $20.00 by this September this bond will mature at par (100). We sold getting this extra premium locked in.

Sell Prov BC 3.20% 2044

We decided to sell this long maturity bond. We had bought the bond when long term interest rates were "cheap". We feel that they are now expensive. We earned 14% over a 10 month period. As well we believe interest rates are generally going to move slightly higher therefore selling this bond lowers our duration and keeps our bond portfolio defensive.