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THIRD QUARTER 2016 - MARKET COMMENTARY

Over the course of the year a handful of big Canadian companies have become even bigger by acquiring American companies and this has dramatically changed the character of the Canadian stock market and the Canadian TSX Index. Most of these big acquisitions are taking Canadian expertise into the United States. When we think of our investments in these large Canadian companies we have to understand that they are now North American businesses. It is these big companies that have the scale and geographical diversity to produce the consistent returns that Avenue prefers, however, this has led to a change in the makeup of Avenue's equity portfolio.

Growth, through expansion into the US, is a well-established Canadian trend over the last twenty years led by the Canadian Banks. The Royal Bank and TD Bank now have market capitalizations of over $100 billion and each has about a third of their earnings coming from outside Canada. By comparison, the largest bank in the US is JP Morgan with a market cap of $300 billion. JP Morgan is also one of Avenue's investments.

The list of Canadian companies getting bigger in the US this year includes Fortis buying a central US electric grid, Emera buying a large electric utility in Florida, TransCanada buying a big Eastern US pipeline business and Enbridge buying a similar but complimentary energy infrastructure business that is also North American in scale. Enbridge, which we consider a core holding at Avenue, will have a market capitalization of almost $100 billion after their merger is complete. As well, Alimentation Couche-Tard is buying a large convenience store chain in Texas, while Potash and Agrium are trying to merge into an agricultural industry giant with a big US farm retail distribution business.

We would like to say that these deals into the United States are driven by optimism and opportunity. But going through the details we find the same story every time. Many Canadian companies express that they actually can't get anything done in Canada. Whereas in the United States, projects can get permitted and built in a much timelier fashion.

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For an investor, it is the dynamic of a project getting built on time and on budget that drives the investment return. For companies that build 'things', the math is very simple. If a project needs a hurdle of 10% internal rate of return to take on the amount of associated risk, and then the project gets delayed 2 years, the result is the rate of return can drop to say 5% and it is not worth taking the risk. The project does not get built.

The top 10 companies in the Canadian stock market by market capitalization:

Royal Bank	**$121 billion**
TD Bank	**$108 billion**
Enbridge	**$90 billion**
Bank of Nova Scotia	$84 billion
Canadian National Rail	**$68 billion**
Suncor	**$61 billion**
Bank of Montreal	$54 billion
BCE	**$52 billion**
TransCanada	$51 billion
Canadian Natural Res.	**$47 billion**

The table shows the top 10 largest companies in Canada by market capitalization. In the Avenue equity portfolio, we own 7 out of the 10 – those highlighted in bold. Of these 7 companies, only Suncor and BCE are mostly Canadian businesses. But even here, Suncor owns and operates a refinery in the US and BCE's business may be all in Canada but it certainly relies heavily on delivering US programming to Canadians.

We find that these large Canadian companies have a great advantage by way of their commanding presence in their respective competitive industries. For the most part, it is the Canadian customer that is driving the profitability. We Canadians use big banks because we want our money to be safe. Also, we like to use a dominant cell phone carrier because we want a consistent signal wherever we go. As for energy, once an oil sands project is built, it is comparatively low cost to operate and there is no production decline rate. The world may change but at this point in our economic development big companies have the advantage.

Avenue’s exposure to large cap stocks has increased as this stock market trend has unfolded. Where last year Avenue’s equity portfolio was 30% weighted to smaller companies, that exposure has fallen to about a 13% weighting today. Not only are the larger companies profitable but we are able to find investable businesses where the valuation is appropriate.

We easily could have spent this entire letter on risk analysis of the many looming disruptive events. We are not ignoring world events, we just wanted to discuss what we feel is an important topic that is not front page news. Now, this letter will address the current hot topics. Brexit continues to unfold and the property market in London and New York is starting to be marginally softer. The Vancouver property market has stalled given the 15% foreign-buyer tax. In Europe, Italy is to vote in a referendum similar to Brexit, while Deutsche Bank, Germany’s largest bank, might be insolvent. The US federal reserve bank seems determined to increase short term interest rates in the US over the next six months. The US election, say no more...

It is common to have one or two disruptive events at the same time but not six at once. With the current high level of stock market valuation, in combination with the nervousness of investors, we could easily see a drop in stock prices. We conclude that the result of any of these disruptive events may be a stalled economy, which then perpetuates this world of lower-for-longer interest rates.

Given this outlook, we feel well positioned due to the defensive nature of Avenue's existing equity portfolio. Our cash position is about 12%, dividends are constantly coming in, and we have a few investments coming to a natural end and becoming cash, like Sirius Satellite Radio. We will add to our list of high cash flowing investments if an opportunity is presented.