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SECOND QUARTER 2017 - MARKET COMMENTARY

The Avenue Bond portfolio is up 1.3% for the first half of 2017 as the expectation of higher inflation and a sell-off in the bond market has not materialized. The Avenue Equity portfolio is up 1.0% for the first half of 2017. While we have not had a market pull back this year, after a good performance in 2016, the type of income producing stocks that Avenue invests in seem stalled as investors' attention remains on technology and more specifically disruptive technology companies. We believe that stock market investors will come back to focus on income at some point, but we need to be patient.

Interest rates seem to reflect a contradiction with traditional investment theory. The North American economy continues to grow at about 2%, unemployment is now low and yet there is no sign of general price inflation. We might get inflation at some point but for now the picture is more complicated. The overall debt level of governments and individuals remains high which limits the ability to accelerate spending. Also, disruptive technology continually makes the economy more productive at the expense of traditional jobs. So, while GDP growth of 2% and inflation of 2% has the appearance of stability, inside every sector of the economy there are a great many winners and losers. They just seem to cancel each other out.

We have observed that investors have lost some of their interest in securities that generate income. As we have written many times, Avenue’s aim is to generate less volatile returns than the overall market. Our strategy is driven by focusing our investments on companies that produce consistent profits. In an environment where the 10 year Canadian Government Bond offers a return of 1.4% we would normally expect investors to be attracted to stocks with higher dividends. However, we now have two infrastructure investments in AltaGas and InterPipe that yield almost 7%. With that amount of income difference, we have to ask ourselves if there is something wrong with these companies since the yield is relatively high. However, our research indicates that these businesses are actually getting stronger, which means we can expect higher dividends in the future.

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In the stock market, investor interest is focused on technology and disruptive technology seems to be the new mantra; if you are not disrupting then you really have no place in the new economy. This month's Case Study presents a more detailed discussion. Why this argument is self-perpetuating is that it is very hard to argue against the success of a company like Amazon, which truly is making many business models obsolete. If you are not invested in Amazon, then it looks like you have your head in the sand.

As investors who are seeking consistent income, we believe we are faced with three decisions. First, if all businesses are getting disrupted then we need to get out of the way of obvious train wrecks. The Hudson Bay Company is a good example. A few years ago, The Bay was a decent business that happened to have a lot of real estate value in the stock. Today we see that their core retail business is struggling as the internet age progresses.

Second, if we acknowledge that this is the new age of technology, then why don't we buy stock in tech disrupting companies such as Amazon, Google and Facebook and be done with it. However, this would conflict with our investment strategy because these fantastically successful businesses trade at a very high multiple to earnings in the stock market. The problem is if technology shifts again or profits don't materialize, then there is no inherent value and the stock prices can go down significantly.

Third, we can embrace disruption and find companies that are hard to replicate. We can make sure our traditional businesses are evolving as users of disruptive technology or, where the valuation is compelling, we can own a few of the direct disruptors themselves.

Referring back to our investments in infrastructure, no matter what the internet can accomplish, it would be very difficult to replicate the pipeline network that InterPipe has already built. Having already given the Hudson Bay example, we do have an investment in Leon's. It is still hard to sell bigger house hold items online, as buyers like to sit on a sofa before making a major purchase. Also, Leon's is spending a great deal of money on inventory and distribution management systems to maintain their position in the industry. Another example is Canadian National Railways where driverless trains are a near-term reality, well ahead of driverless cars. A driverless train does not require a pension plan, which will significantly reduce costs. Lastly, we took the opportunity to invest in Microsoft and Apple at points in time where the valuation was compelling and where the market was less sure of future earnings.

To summarize, these investments all share common characteristics: the underlying profitability of the business, our understanding that each company is a technology leader in their sector, and most importantly our assessment that we did not pay too much for the underlying cash flow. If we focus our investments on the income generated by the business, at some point the stock market will reflect the value, no matter how unfashionable the sector might appear.