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THIRD QUARTER 2017 - MARKET COMMENTARY

Avenue's fixed income and equity portfolios historically have little turnover of the individual securities from year to year and 2017 has been no exception. However, this year has been notable in terms of big moves in interest rates, the Canadian dollar and many stock market sectors and individual stocks. In this quarter's letter we would like to discuss where our portfolios stand in relation to these many moves.

Probably the biggest news in the financial world has been the decision of the US Federal Reserve Bank and the Bank of Canada to raise short term interest rates. A decade has now passed since the financial crisis of 2008. Raising rates was always going to be big news and this is not to say that raising interest rates was not expected, but that the timing was uncertain. We have been positioning the Avenue bond portfolio over the last few years for just such a change in interest rates.

Bond investing is really quite simple. See this month's Case Study on compounding in the bond market for more detail. When interest rates go up, bond prices go down. So, Avenue's bond portfolio is up only 0.4% in 2017. We have received 3% in interest income but that has been offset by the fall in the market price of the bonds. With perfect timing, we would sell all our bonds, wait for interest rates to go up then buy back the bonds. However, we run a real risk of not guessing the timing right of such an interest rate move. Also, it is very expensive to get the timing wrong because when we don't own the bonds, we don't get paid any interest income either.

We have positioned Avenue's bond portfolio to address the challenge of timing a rising interest rate environment by owning bonds with a shorter term to maturity. We still get paid interest but as the bonds mature faster, we are able to reinvest sooner at the new higher interest rate. So, while total bond returns have paused for a bit, we are in much better shape to capture higher returns going forward. Many Avenue clients will have and will need bond portfolios for years

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into the future. Higher interest rates will have by far the biggest impact on future returns compared to any short-term losses.

The strong Canadian dollar is the next big story of 2017. We have discussed several times in previous letters that we believe a $0.85 Canadian dollar is a level where we would be indifferent between making a Canadian investment versus a US investment. We don't have to make a call as to where the dollar is going. We simply have to acknowledge where value is and adjust our new investments incrementally.

For that brief period where the Canadian dollar was at par with the US, we actively looked to make investments outside of Canada. For the last two years, with a Canadian dollar in the low $0.70 area, we looked to bring money back to Canada and invest in domestic businesses. As the Canadian dollar gets closer to $0.85 to the US dollar, the currency is a less important consideration for a new investment. Avenue's equity portfolio is currently 26% invested in companies outside of Canada.

Finally, we would like to discuss the stock market from a Canadian investor's perspective. The headline has been "Canada is the worst performing stock market in the world". Here we can accurately use the term disingenuous analysis as there is a lot more going on inside the Stock Market Averages as represented by the indexes. Yes, the main US S&P500 stock market index is up 14% year to date, but that is only a 5% gain when converted back to Canadian dollars. The Canadian TSX Composite is up 3% in 2017, which makes the comparison between the US and Canadian returns not that dramatically far apart.

More importantly, the performance of the US S&P500 Index is now being completely skewed by a handful of mega-cap technology stocks. Here we are referring to the Google, Facebook, Apple and Amazon effect. The 10 largest stocks in the S&P500 are now 20% of the index. The 20 largest stocks are 1/3rd of the index. The bottom 100 stocks of the S&P500 represent only 3.6% of the index which is the same size as Apple on its own. Therefore, big tech is having a good year and driving up the index, but most stocks in the US are flat.

Why this is so important is because index investing has become the norm for most individual investors, as they are all basing their savings and retirement on the same handful of very big, mostly tech companies. Buying the index makes investing simple and accessible for many people. However, diversification, which is the core principal of risk management, is being completely ignored, mostly because it makes the story too complicated. If we are looking for the next bear market crisis, index concentration is certainly on the list of major emerging risks within the financial system.

When we dissect the Canadian TSX Composite index we have always been faced with a concentration problem but here it is different from the US. The TSX Index is roughly 30% financial stocks, 15% energy stocks, 15% Mining stocks and 40% everything else. We have argued many times that given the importance of diversification, you would never use the TSX index as a framework for a long-term retirement type portfolio. You can also see why the Canadian index has lagged in 2017. Banks stocks stalled when interest rates went up. Energy stocks stalled, until just recently, as the oil price continues to be in the $50 area. And mining has been a mixed bag.

When discussing the stock market in this way we are trying to highlight what we at Avenue are not. Avenue's equity portfolio is diversified with a various mix of sectors, business type and currency. We also believe we have the ability to withstand a rising interest rate environment. But similar to the bond portfolio, Avenue's equity returns seemed to pause for most of 2017.

However, by mid-August it was apparent that although the stock prices were not moving, our underlying investments were fundamentally sound and improving. For example, in terms of simply capturing the return from dividend income, the Canadian bank stocks were yielding 4%, two of our pipeline stocks were yielding 7% and two of our real estate stocks were yielding over 6%. When September arrived, we were rewarded for our patience as the Avenue equity portfolio is up 4.4% for the year to date.