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FOURTH QUARTER 2019 – LETTER

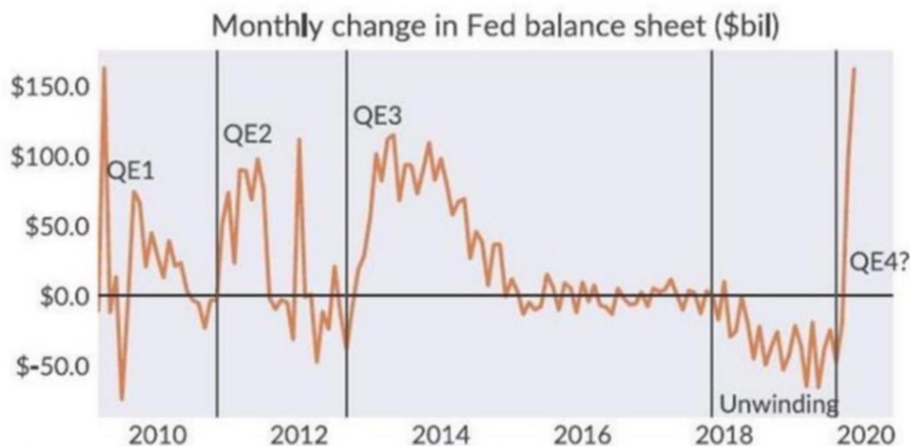
Avenue 2020 Vision

This past year was a year to celebrate Avenue's unique equity strategy where the foundation of the portfolio is built on limiting the risks we take, instead of trying to 'beat the stock market' in any given year. For 16 years we have developed our brand and place in the Canadian investment industry where when you think of Avenue, you think of stability. Investment stability is achieved by diversification of the portfolio, the stability of the underlying investments, and rigorous attention to avoid owning securities that we believe are overvalued.

This past year, Avenue's equity portfolio performance clearly demonstrates that a conservative investment strategy does not have to sacrifice capital gains appreciation. In this letter we will highlight the key features of this strategy and why it is best to first care about protecting the downside, which then makes it easier to stick with our investments in the face of frequent pessimistic forecasts. Also, we will explain possible investment risks in the year ahead and where we see opportunities for Avenue's equity strategy.

Bonds

First, we would like to discuss Avenue's bond portfolio and the current level of interest rates. For the past several years we have maintained our view that we are in a very low and range-bound interest rate world. Then came 2019 where almost every financial sector and asset went up in value. A year ago, our year end letter for 2018 conveyed that almost all investment sectors were down. Markets where everything is down, and markets where everything is up, are both extremely unusual. We believe both can be explained by the US Federal Reserve's tight monetary policy at the start of 2019, then its swing of 180 degrees mid-year to its present easy monetary policy.



Source: St. Louis Federal Reserve

The US Federal Reserve monetary policy is shown to be overwhelmingly important on a global scale. Because of the overall level of debt in the North American economy, interest rates can only go so high and we expect an easy monetary policy should allow the economy to expand. But our expectations for returns from Avenue's bond portfolio will remain in the 3% to 4% range over time. However, because last year's bond return was so good, we wouldn't be surprised if returns were slightly less near term. We recommend Avenue's bond portfolio for people that absolutely require their money and income to be there when they need it. Where more risk can be tolerated, and with a longer time horizon, we believe the better value is currently in Avenue's equity portfolio and its diversified group of income producing stocks.

Avenue's Equities = Lower Risk

We often describe Avenue's equity strategy as limiting the downside risk. But in so doing, we can't always expect to get huge returns from the upside in great stock market years either. One of the most important tenets of long-term investing is to win by not losing. If we can limit our downside in bad markets, we maintain the value of our portfolio and can take advantage of good markets, like last year's. Also, if we have stable businesses, with limited downside, generating income, it gives us the peace of mind to stay invested through weaker stock market.

This past year, 2019, was a great example of many pessimistic forecasts from market participants, many of which have been detailed in previous letters. Let us remember the China-US trade war and tariffs, the Canada-US trade renegotiation and tariffs, and Brexit, all of which still exist. At the start of 2019, we were recovering from a severe market decline where forecasters predicted impending recession and by last August, it was expected that we were headed into a recession within months. The recession didn't happen. But there were multiple opportunities where the temptation was to get out of the stock market and sit on the sidelines until there was more clarity. Removing ourselves from the stock market would have resulted in missing out on one of the best years for returns this decade.

How do we approach and define low risk at Avenue? We evenly distribute and diversify our investments in publicly traded companies across the many vibrant sectors of the economy. In Avenue's case we use eleven distinct categories from real estate and infrastructure, to financials, technology, and healthcare. Within these sectors we try to find and invest in the companies that are the best stable income generators. Unlike other investors, we do not try to guess if a stock is going up immediately or if a currently unprofitable business will make a lot of money in the future. At Avenue, we stick to investing in businesses that are making money now, where we can capture that income stream by being patient investors. Then most importantly, we must be disciplined on valuation and not overpay for the amount of income the businesses generate.

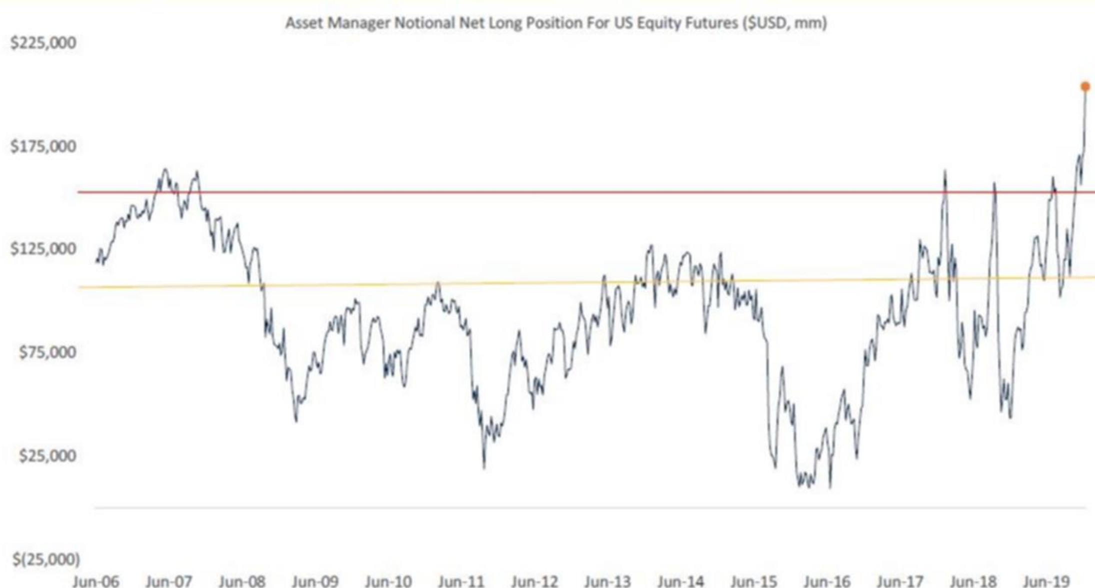
Avenue always likes to start by looking at 'Canada First', which is an important advantage overlooked by other managers. Right now, and this might change, there is a real opportunity to invest here in Canada. Canada is totally out of fashion as an investment destination and out of fashion is a good thing. If we had tens of billions of dollars and needed our investments to go up immediately, then we would agree that Canada is harder to get excited about. But we believe there are many businesses here in our stock market that have a North American business footprint and are being ignored by investors. The businesses we like generate consistent income, which gives us the opportunity to be patient. The Canadian dollar is also low compared to the

recent strength of the US dollar. We feel there is a potential reversal to this trend in the coming years given the United States' spiraling debt and deficits which are now in the trillions of dollars.

The last major differentiator in Avenue's equity portfolio is our 20% allocation to higher income producing bonds and mortgages. Our current mortgage exposure is not directly in individual mortgages but in two MICs, or Mortgage Investment Corporations. In this part of the portfolio we get a consistently high-income stream that can be reinvested over the course of the year, when we find opportunities.

Where we now see risk

Interest rates are so low that money that has traditionally been invested in bonds is now being pushed into riskier investments. Where we see distortion in valuation is in the US corporate bond market, private equity, venture capital and the indexing of over half of today's new money allocated to the stock market by investors. In the face of all this momentum elsewhere, we believe our commitment to finding value in Canada is a real opportunity. As shown below, the positioning in the US equity futures market is now at euphoric levels.



Source: RBC Dominion Securities

Let's start with stock market indexing. What was a novel idea in 1975 and statistically correct at the time, has morphed into a dominant and distorting force in today's stock markets. The original idea was that if, up to 10% of average investors became 'passive' index trackers then many poor, buy high and sell low decisions would be avoided. Forty-five years later and we are now in the age of the index and the result is an extreme concentration of risk. Last year in the US, **80% of the return** in the technology heavy NASDAQ came from just four stocks: Apple, Microsoft, Facebook and Google. We owned Apple for several years but as of the time of writing we have recently sold our position.

We believe the distortion caused by this concentration is the modern-day version of the Emperor's New Clothes. The concentration of wealth into the top companies in the index will continue until some innocent observer declares to all involved that the valuation is crazy given

the underlying business. While all these businesses are very successful, no company has an indefinite lock on cloud computing or internet advertising. We have made an attempt in this quarter's case study to show how hard it will be for Microsoft to continue to outperform as a stock, just because they are now so big. We have owned Apple and Microsoft shares until recently, but we can no longer justify the high valuation.

As an aside, an Avenue team member was in the Harvard University bookstore over the holidays and commented that on an entire wall of books dedicated to business, there was only one on stock market securities valuation. And it was an Economist publication equivalent to 'Stock Analysis for Dummies.' This is a stark reminder that Avenue's commitment to be traditional investors who own and hold on to shares because we believe in the underlying business, is seen as being amusingly antiquated. As we stated earlier, being out of fashion is good and stock market valuations have to come back to underlying earnings at some point.

This has been a longer than usual letter and we want to keep it to an easily digestible size. We tackled the topic of venture investing in last quarter's Case Study on WeWork, which you can find on our website. Later in the year we will discuss the US corporate bond market and private equity boom and why we should avoid them. We imagine we will be in this odd investment climate for a while longer and we haven't even had time to touch on the brave new world of ESG investing yet. ESG stands for Environmental, Social and Governance and it is changing professional investors' behavior everywhere.