Market Commentary
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TETREM CAPITAL MANAGEMENT

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Stay on track
Emotional decision making is the enemy of all investors. Too often investors find themselves selling when they should be buying and vice-versa. Typically, emotions are at their highest when markets are volatile and the co-dependent loop of anxiety between investors and markets feeds upon itself. While it is easy to assume that bear markets create the most emotional investment reactions, some of the craziest investor actions happen during bull markets. After all, bull markets give rise to investment bubbles that can prove hard to resist. Two of the larger investment bubbles of all time have occurred in the last 20 years. At the turn of the century there was the bubble in technology stocks which was followed a few years later by a U.S. housing bubble. Both eventually popped, resulting in terrible consequences for the economy, investors and, in the case of the housing bubble, a devastating tragedy for the millions who lost their homes. Fear and greed drive equity markets but there is something else at play when assets go into bubble territory. As renowned investor Jeremy Grantham said, "Watching your neighbours get rich during a bubble is pure torture." Bubbles are a hard temptation to resist. Fortunately Tetrem has historically avoided the temptation, and therefore the damage, of deflating investment bubbles by following a disciplined value approach.

Recently, investor angst has come less from the fear of missing out than from the fear of losing capital, given the uncertain global economic environment and tepid earnings growth. In many ways it is easier to maneuver through such periods than through raging bull markets, particularly for value investors. In our January commentary, we highlighted our focus on blue-chip companies given their strong economic moats and our ability to buy them at reasonable valuation levels. Since publishing that commentary, the market has been volatile while our approach has remained steadfast. We are taking a measured investment approach by focusing on downside risks and building portfolios of high conviction holdings that are financially strong and generate persistent cash flows. During the first quarter of 2016 we reduced the number of holdings in our Canadian and U.S. portfolios, concentrating capital into our highest conviction positions. Largely due to these changes, portfolio turnover increased during the quarter; however we expect turnover to slow down for the balance of the year. Volatility affords opportunity to patient investors and we were able to use emotionally driven movements in individual stocks to enhance the overall risk/reward profile of our portfolios during the quarter.

The myriad macro-economic issues that have been plaguing investors over the past few years are not going away anytime soon. China needs to re-task its economy towards domestic consumption and away from its reliance on mercantilist policies for growth. Global demographics show an aging

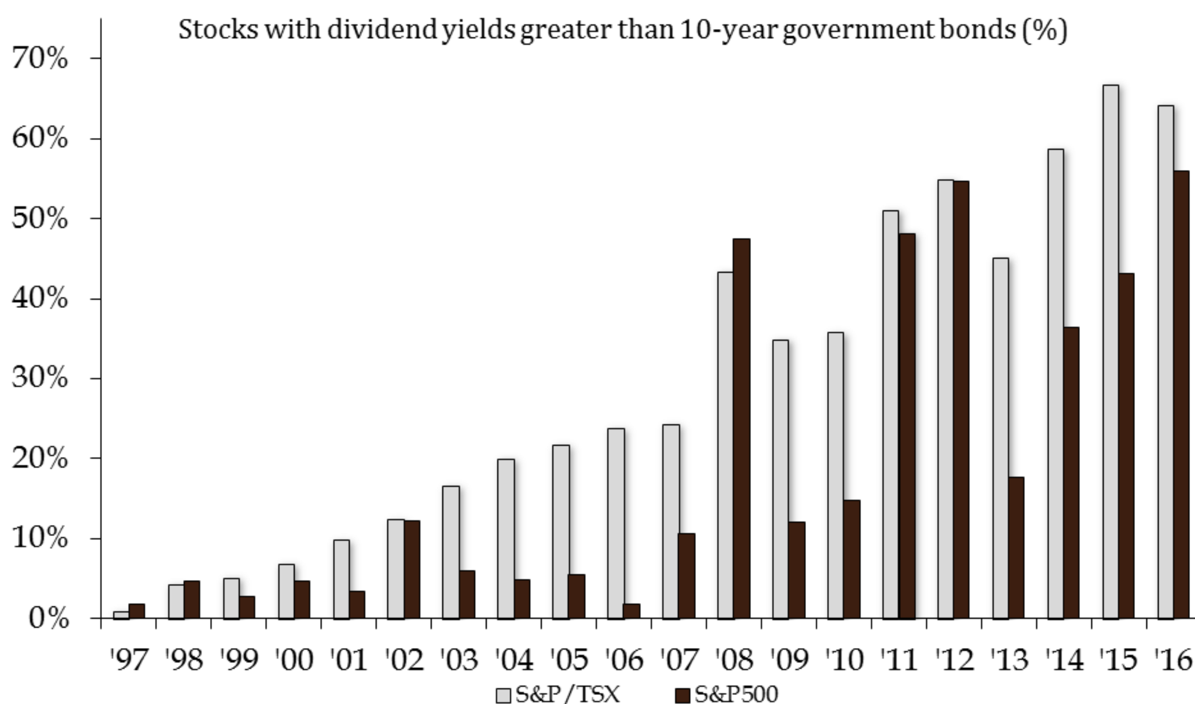
population that will limit future growth, particularly in developed economies such as Japan. Continued tepid economic growth is a reasonable baseline expectation that we are embedding within all of our investment analyses. It is becoming increasingly clear that the post financial crisis era will be defined by negative interest rates, a situation that was almost incomprehensible just a few short years ago. It is hard to imagine market volatility going away anytime soon. The key to maneuvering through this period will be maintaining a disciplined approach when making investment decisions.

Conservatism in decision making is one of the simplest ways to manage downside risks in many of life's undertakings. I was recently reminded of this when I had the opportunity to cycle on the new indoor velodrome in Milton, Ontario. The track cycling facility was built for the 2015 Summer Pan Am Games which were hosted by Toronto. Getting on a fixed-gear bike without brakes to ride on a wood track with 42-degree banks may not appear to be the best way to avoid risk. However, similar to investing, the rewards are very satisfying if the effort is executed in an intelligent manner. When getting certified to ride the track, the first thing you learn is the importance of safety. Simply going as fast as you can is a recipe for disaster, yet to be successful, speed must be maintained. Critically, you need to have an awareness of other riders on the 250-meter track if crashes are to be avoided. Holding a straight line and steady pacing are key to survival on a track crowded with riders of various abilities. Erratic movements and frequent speed changes inevitably lead to accidents that will prove costly from both a physical and psychological perspective. No one wants to be on the side of the track pulling slivers out of their derriere. Yet people love riding on the velodrome. As with any athletic endeavour there are physical and mental health benefits. While there are risks, an indoor velodrome has the advantages of no inclement weather, a lack of potholes and the complete absence of motorized vehicles – the biggest risk of all to the outdoor cyclist. Like riding on the velodrome, stocks are not without their risks.

The key to safety both on the track and in investing is to stay focused and take a measured approach. This should not be taken to imply that high risk aversion is the way to go. Proverbially stuffing the mattress with cash is the investment equivalent of transforming into a stagnating couch potato – the long-term implications are not good. In today's zero-interest rate environment, capital invested in blue-chip stocks that pay reasonable and growing dividends can be expected to compound at mid-to-high single-digit rates. This may seem unexciting, but it shouldn't. Einstein famously stated that compound interest is the most powerful force in the universe. Saving and the power of compounding may appear boring and conservative, but they are the keys to building wealth. Cycling on a velodrome is literally going in circles, but you cannot forget, and the legs will remind you, that real distance is being covered along with progress towards goals.

In a low growth, low nominal return world, dividends are increasingly important to investment returns. From this perspective, equities offer good value. At the end of the first quarter, 56% of

stocks within the S&P 500 Index offered dividend yields greater than the 10-year U.S. Treasury yield of 1.77%, a historically wide spread. In Canada, the yield advantage of equities is even greater with 68% of stocks in the S&P/TSX Composite Index offering an income stream greater than the 10-year Government of Canada bond yield of 1.22%.



Data from Strategas as of March 31, 2016

Across the Atlantic, the sovereign bonds of Italy and Spain — two countries that five years ago offered investors two-year yields of 7.6% and 6.7%, respectively, to compensate for default risk — are now at negative yields. We know that negative rates are creating pricing distortions of all types; what we do not know is how, and when, these distortions will be resolved. Some assets are clearly overvalued, while others are trading at discounts to fair value. The key to both surviving and prospering in this environment is to stay focused on value, avoid emotional decisions, and let compound returns do their job.

We are cautiously optimistic that the dynamic within the market is shifting toward value stocks. The S&P 500 Index appears to have bottomed on February 11, 2016, and since then North American equity markets haven't looked back. Early results into the third week of April indicate that our

portfolios are acting well in this recovery. From the February market lows, Tetrem's Canadian Equity Value portfolio is up 17%, outpacing S&P/TSX Composite Index's advance. In the U.S., the portfolio has advanced 14% and April's relative result thus far have been markedly better than that of the benchmark. Investors are shifting capital toward undervalued companies across sectors; if this trend persists we believe our portfolios are positioned to continue performing well.

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