

Market Commentary

Third Quarter 2015



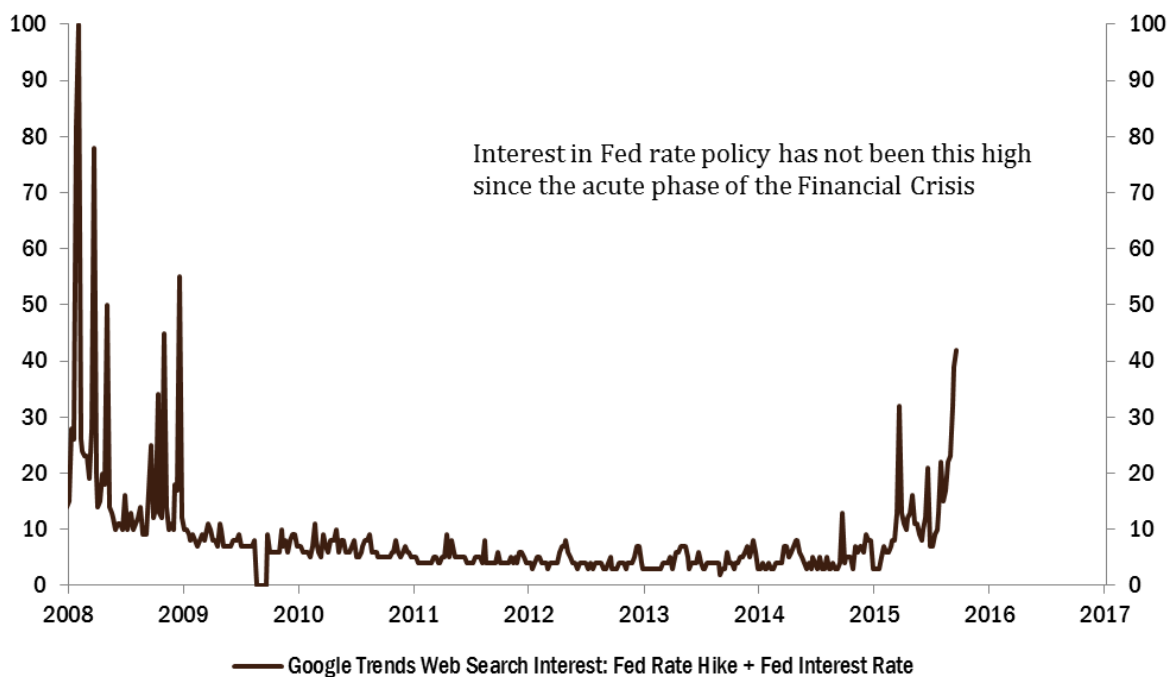
TETREM CAPITAL MANAGEMENT

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Just go about your business

Back in a previous life I worked with a very smart software programmer who had immigrated to Canada as a young man. He held a decidedly eclectic blend of Eastern and Western capitalistic views. In addition, he did not have the patience for superfluous information or rambling thoughts. When caught in a conversation that was going sideways, his typically cynical refrain to the offending party was a calmly stated “just go about your business.” Yes, I fell victim to this on a number of occasions. Recently, memories of this Russian-accented imperative have swirled in my head, triggered not by Putin’s address to the United Nations, but by the endless discourse over when, and if, the Federal Open Market Committee (FOMC) will increase short-term interest rates by 0.25%.

Google Trends Web Search Interest: Fed Rate Hike and Fed Interest Rate



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The debate has been raging for well over a year, but attention on U.S. Federal Reserve Board (Fed) policy crescendoed heading into the September 17, 2015 FOMC meeting, as shown by Google search activity (illustrated in the preceding chart). As CNBC viewers can attest, it seems that the channel is fully dedicated to discussing and forecasting Fed policy. Perhaps it should be renamed FEDTV. Beyond the redundancy of the debate, it has become clear that attempting to predict Fed policy decisions is a fool's game. What became even more evident after the September decision to leave rates unchanged is that successfully predicting the outcome actually provides you with little, or no, edge on the market's reaction. Even if you were given the Fed's decision a day in advance, you would be no better equipped to profit from the market than an investor who had completely ignored the whole debate.

When the "no change" announcement came out, the market's knee-jerk reaction was to rally. This proved to be short lived. Equity markets sold off over the ensuing days as the Fed's decision was taken as a negative view on U.S. economic activity – or so went the prevailing commentary. In the aftermath of the market weakness, a typical pundit response was "I had hoped they would go." Since that time, equity markets have rallied as the "no increase" decision was later viewed as a positive for stocks, given an "accommodative Fed." Evidently, the story changes with the market's direction. The reality is that no one knows how equity prices will respond to the first U.S. interest rate hike since before the Financial Crisis. The commentators can, and will, discuss it *ad nauseum*, but the fact is that they were in guess mode prior to September, and they remain there today.

There are two schools of thought on what the Fed ought to do. One school believes that the global economy cannot handle an increase in rates and that so increasing rates would prove to be a policy mistake. The other contends that a rate increase is long overdue and must happen in order to reduce the dislocative effects of a zero interest rate environment, such as the risk of capital misallocation. Fatigue with the debate has given rise to an alternative view, one that wants the Fed to just go about its business and raise rates. It is no wonder that the narrative from market pundits remains so dynamic.

The next FOMC meeting takes place at the end of October, and you may very well be reading this letter after the event. With no scheduled press conference, a rate decision is not expected at this meeting. This pushes the resumption of intense Fed watching to the December 15-16 meeting. Even with 100% certainty on what the Fed's decision will be, the question remains on how to profit from it. Is a rate increase going to be good, bad, or ugly for asset prices? There are so many variables at play; only time will tell. One of the key variables will be the reaction of the U.S. dollar to a change in policy. As with the stock market, it is nearly impossible to predict which way the dollar will move, even with perfect foresight on interest rate decisions. The greenback has been in rally mode ever since markets became convinced of the inevitability of an increase in U.S. short-term interest rates. Will an increase in rates create further appreciation in the greenback? Or will the market take a "one and done" view, leading to currency stabilization? Will the Fed, frozen by the fear of making a policy mistake, do nothing and thereby trigger a correction in the dollar? Again, with so many

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questions it is difficult to handicap the outcome, but currency markets bear watching as U.S. dollar strength has been a major determining factor on equity market movements over the past year.

While market watchers collectively spend excessive time and energy discussing potential Fed policy and its implications, the irony cannot be lost that productivity – a critical component of sustainable economic growth – ultimately suffers as a result. This uncertainty has a negative feedback loop to the real economy, despite the fact we are talking about a mere one-quarter of one percentage point change in interest rates off a zero-rate floor. Volatility in capital markets and lack of clarity from the Fed are conspiring to influence real economic players, causing them to delay investment decisions and thereby creating a further drag on economic activity. Maybe investors and the FOMC would be wise to heed the advice of my friend and just go about their respective businesses.

Effectively that is what we are doing at Tetrem. We adhere to a bottom-up, value-based approach to stock selection that largely eschews macroeconomic forecasts. How, and where, we invest our clients' capital is not driven by top-down views, though these can lend support to our bottom-up research. For instance, rising short-term interest rates will positively impact the earnings of our investments in the financials sector, in some cases dramatically so. Yet not one individual investment thesis is predicated on higher rates. There is a commonality of investment rationale among our holdings within the sector, mostly relating to undemanding valuations and capital being returned to shareholders through share repurchases and increasing dividends. Beyond that, each investment thesis across our Canadian and U.S. portfolios is predicated on idiosyncratic reasons. The earnings of financial stocks have tremendous latency to higher interest rates, but that is only the sizzle on the steak of an already meaty thesis.

Outside of financials, we are finding attractive investment opportunities across multiple sectors, reflective of a broader value opportunity that is being ignored by the market. Value has been out of fashion, while momentum investing has been hot. As value investors, we will continue to go about our business, following an investment framework that has proven its worth for over two decades; that is, focusing on the best combination of upside potential and margin of safety to protect investor downside. There is no shortage of such opportunities in the current environment and, in fact, the quantity has sizably increased over the past year. There are signs that the tide is turning away from momentum strategies and back in favour of value, a subject that we will be discussing in our next letter. Until then, enjoy FEDTV if you wish. We'll be keeping our heads down, focused on research that provides an investment edge.

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