VULCAN
ASSET MANAGEMENT

1H 2016 Portfolio Manager Commentary

Macro and Markets

The close of the first half of 2016 was marked by an unprecedented move by the United Kingdom to seek an exit from the European Union. This is bad news for the UK, which will have to turn to populist measures to counter the devaluation in their currency as well as the likely economic contraction that will follow.There is a likelihood of monetary and fiscal stimulus measures in the UK in the second half of the year, to add to those already in the Euro-zone, Japan and China. These measures could likely keep equities artificially higher and bond yields suppressed for an extended period of time. Allocation of investment dollars remains firmly influenced by central bankers for the foreseeable future.

Crude oil and gold were the best performing asset classes, producing 30% and 25% gain respectively in 2016 through June 30. Emerging market equities saw a recovery with the exception of China. In US equities, small and mid-cap value stocks were the top performing equity asset class this year, gaining between 8-9%.

Portfolio Performance

The Vulcan Global Intrinsic Value Portfolio appreciated by 3.1% during the first half of 2016 vs. -0.4% return in the portfolio benchmark. For the trailing 12-month period the portfolio benchmark fell by -6.5% as compared to the portfolio return of -1.6%. Since inception three and a half years ago the portfolio has generated gains of 60.5% vs 20.5% for the Portfolio Benchmark in that period. The compound annual portfolio return since inception is 14.5% vs 5.5% for the Portfolio Benchmark.

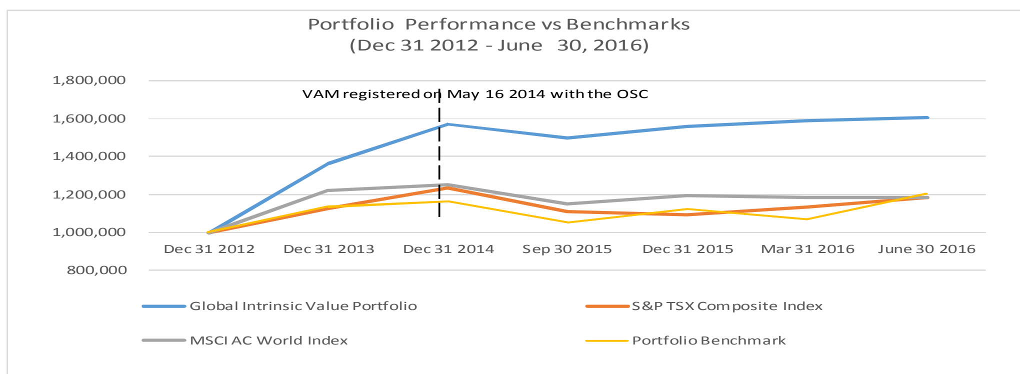
Figure 1: Portfolio performance from Dec 31, 2012 – June 30, 2016

Portfolio Performance versus Benchmarks

	Gain / (Loss) %		
	1 year July 1 2015 - June 30 2016	Since Inception Dec 31 2012 - June 30 2016	Compound Annual Growth Rate
Vulcan's Intrinsic Value Portfolio	-1.6%	60.5%	14.5%
Portfolio Benchmark*	-6.5%	20.5%	5.5%
MSCI AC World Index	-5.4%	18.6%	5.0%
TSX Composite	-3.4%	18.4%	4.9%

**The Portfolio Benchmark is MSCI AC World Index (70.0%); Canadian Preferred Share Index (20.0%) and Dex Bond Universe (10.0%)*

Chart 1: Portfolio Performance Vs Benchmarks



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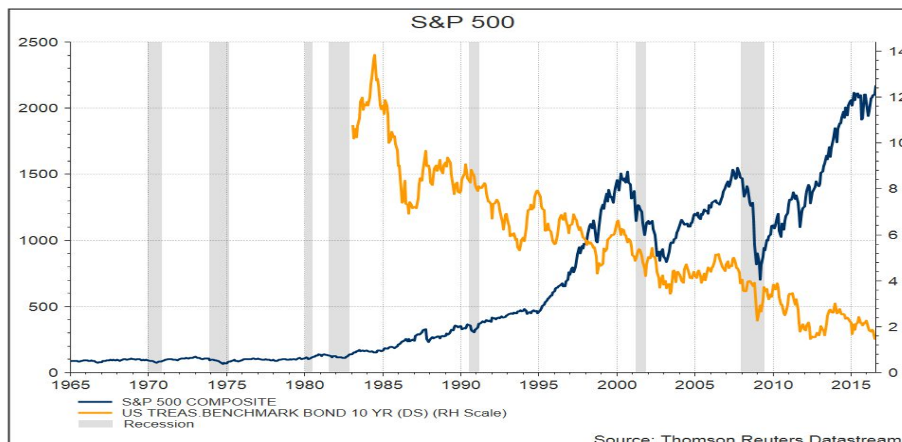
Investment Overview and Portfolio Strategy

Valuations of US and Canadian equity markets are at all time highs. The S&P500 trades at 18.5x as compared to a 10-year average of 14.9x (based on the total expected earnings of index constituents one-year forward), while the Canadian TSX Composite index trades even higher at 19.4x, 1-year forward earnings compared to a 10-year average of 15.3x. If corporate earnings were growing at an accelerating pace then these kinds of valuations are understandable. However, corporate earnings have declined in 2016 for the second consecutive year. The price gains we have experienced in risky assets such as equities is a function of higher multiples applied to corporate earnings as well as expectations that earnings growth will resume over the next three or four quarters.

US large cap equities have not done as well as small/mid-cap stocks, gaining just 2.7% year-to-date as compared to 8-9% gains in those categories. Canadian equities too have done well thanks to a significant jump in small cap stocks largely concentrated in the energy (up by 17.0%) and materials sector (up 50.0%). Dividend yield remains the dominant theme, with US telecoms and utilities both up 21.0% and consumer staples up 9.0%; Canadian utilities and telecoms were up 15.0% and 12.0% respectively, underscoring how the market (ex-energy and materials) remain willing to pay up for defensible yield.

The elevated valuation levels are a direct consequence of artificially low interest rates, manipulated by major global central banks. The fixed income market has long ceased to provide an acceptable level (relative to risk) of income. Individual investors, mutual funds as well as pension funds and insurance companies have been pushed into dividend yielding equities. This situation is unlikely to change in the near future. It is likely that global central banks will continue to ease on interest rates and money supply. As a result, there is limited potential for a soft end to the most manipulative phase of the world's collective economic history. It is rational to expect that equity prices will remain elevated for as long as interest rates remain low. (Note: Please see Chart 2 for a decline in bond yields since the late 1980s and the corresponding opposite impact on US equities)

Chart 2: Rising S&P500 vs declining 10-year US treasury bond yield



Portfolio strategy:

Our strategy remains focused on buying individual securities, though as in the past we may include indexes of select individual economies in our target investment set as valuation differentials get more pronounced. We continue to avoid oil and gas companies even though the sector returned to favor in the first half of the year. It is likely that the bounce in these stocks is here to stay given the fact that most energy companies have raised new

capital, through equity, high yield debt, convertibles etc, though bank financing is still not available to them. Being domiciled in Canada we are exposed to the effect of energy and currency volatility even if we don't own energy sector securities directly. Owning these securities only increases the risk of permanent loss without providing any commensurate benefit to long-term returns and portfolio stability. As a case in point, the 7.1% gain in the Canadian dollar so far this year adversely impacted returns on our US equity holdings.

As part of our balanced investment approach, we intend to eventually hold up to 10.0% in domestic corporate bonds assuming we can find requisite value (zero portfolio allocation so far, though we have identified some securities we would like to own) in addition to a minimum of 20.0% in preferred shares to aid is generating our targeted 3.6% portfolio yield. Seven out of our 24 portfolio companies (representing a 30.0% portfolio weight) increased dividends so far this year. And, any further improvement in the 3-month Canadian treasury-bill rate will increase dividend flows from our floating rate preferred share investments.

Figure 2: Dividend increases by portfolio companies in 2016

Company	Country	Div Increase
CISCO	US	25.0%
CH Robinson Worldwide	US	15.0%
Corning	US	12.5%
PNC Financial	US	8.0%
AIMIA	Canada	5.0%
United Technologies	US	3.0%
Wells Fargo	US	1.5%

Our target is to grow the portfolio through a mix of sustainable growth in dividend and interest payouts and realized capital gains. We think that a 5-7% gross annual return over a market cycle is acceptable under the constrained macro situation and persistent over-valuation in several segments of the market.

Portfolio Changes during 1H 2016

New Holdings	Portfolio %	Sector	Country
Holly Frontier Corp	3.4%	Energy	US
Deletions			
ABB	1.5%	Industrials	Switzerland
Dorel Industries	0.3%	Consumer Discretionary	Canada
Time Warner	1.1%	Consumer Discretionary	US
Additions to Existing Positions			
Bird Constructions	0.4%	Industrials	Canada
Linamar	2.6%	Consumer Discretionary	Canada
Reductions from Existing Positions			
N/A	-	-	-