PERRON & PARTNERS
WEALTH MANAGEMENT

Interest Gained™

Our best insights and updates.

Oct. 2016 **Issue No. 08**

Featured Articles

> "In this fall issue, we'll show you some early signs of a recovery in the energy sector, comment on the US Presidential cycle as we close in on the election, and provide an insider's view of our enhanced portfolio structure."

Considerations for Fall

Gary Perron, CFA, Portfolio Manager, Founder

Welcome to our eighth newsletter. We hope you and your family enjoyed our Alberta summer. This newsletter introduces Diane Pang, who joined us to manage a fixed income mandate for our clients' capital preservation needs.

A couple of themes we are monitoring closely:

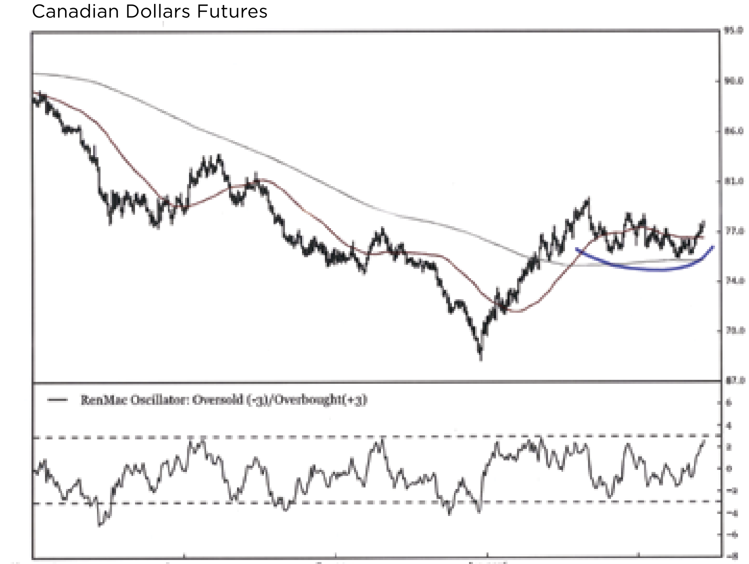
One of our technical analyst sources, Renaissance Macro (RenMac) speaks to "Signs of a Turn in Energy" in their weekly note: "While oil appears overbought in the near term (a volume of purchases has been made at a price above fundamental valuation), their proprietary RenMac oscillator is showing indications of momentum (potential for continuing trend) and the potential for crude oil and CAD to move higher together."

Notice the blue bottoms on the following two charts (Canadian Dollars Futures and Crude Futures). RenMac is saying that it is possible that both factors act as a basis to maintain oil prices. While the timing and certainty of the pattern within these charts is better viewed as an estimate (oil could drop first before it goes on a run), the trend is clearer: typically when crude and CAD have historically formed a base, it has led to a bull oil market.

Diane comes with over 10 years of fixed income credit management experience, recently having managed a fund with over $1.2 billion in assets with a major institution.

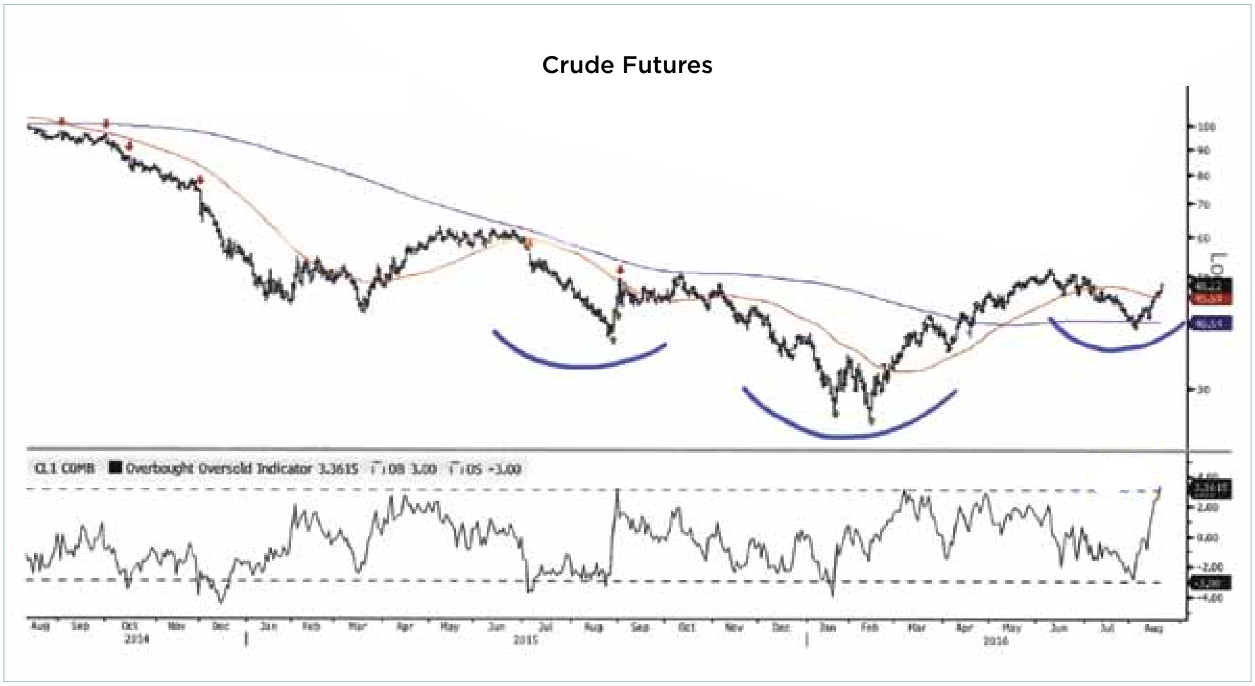
In this newsletter, Darrin Erickson will address the US presidential cycle, while Chris Bolton reflects on a US energy conference and provides a summary. Jason Issac and Derek VanGenderen explain some portfolio parameters around our enhanced portfolio structures and factor performance and Shawna Perron addresses Family Enterprise Advising.

Canadian Dollars Futures



Source: Renaissance Macro Research

Considerations for Fall *Cont'd*



Source: Renaissance Macro Research

It is very difficult to get a complete view of the fundamentals of supply and demand for crude oil, but it is clear that the efficient auction market for both crude oil and CAD are showing some positive technical signs. This is critical not only for the energy sector, but also the Canadian financial marketplace. As a result, we have been increasing our Canadian weightings in the portfolios.

We continue to focus the vast majority of our resources on searching for investment opportunities in public companies that generate free cash flow and have the potential to increase dividends and purchase their own stock. The cyclical sectors (energy, materials, forest products, agriculture, etc.) are exceptions to this investment style, therefore we typically carry smaller weights in the portfolios within those sectors. The challenge is always timing in investing and exiting at the right time in the cycle. With that stated, we have been increasing our weights in the cyclicals. We think we may be in the earlier stages of a commodity price recovery, which would be good for Canadian businesses.

Our other major theme is investing in Canadian small- and mid-sized businesses. We have a great portfolio of small businesses that are benefiting from the lower Canadian dollar and exporting mainly to the US. These companies are trading at discount valuations to the large Canadian universe with better revenue and earnings growth forecasted over the next year.

We wish all our clients a great fall, and to the snowbirds – safe flights and drives down south.

Gary Perron, CFA
Portfolio Manager, Founder

How Do Savers Save in Fixed Income?

Diane Pang, CPA, CA, CFA, Portfolio Manager

We are now living through a new era of low interest rates that provide little incentive for investors to actually park cash into bonds: where the target Bank of Canada overnight rate is 50bps, the Canadian Bond Universe yields sub 1.8% and "riskier" Canadian Investment Grade Corporate Debt Universe yields under 2.5%.

The question is: how do savers save in fixed income? Joining Perron & Partners (Perron Asset Management) was an exciting opportunity for me, as I got to sit down with my new colleagues and create from a blank slate.

After assessing the current interest rate environment and the needs and concerns of our clients – we looked to create a fixed income offering with the main objective of providing value to our clients with the focus on mitigating risk.

Our solution: Kipling Strategic Income Fund ("the Fund").

Being "strategic" is key; this Fund arms us with the appropriate tools to generate returns, but our focus is to keep it simple and to provide a reliable stable source of income (with a target distribution of 3.5%). The Fund's mandate allows for a range of investable fixed income securities including: short-term/money markets, government bonds, investment-grade and non-investment-grade bonds, convertible securities and preferred shares (please refer to our Offering Memorandum dated August 5, 2016 for further details).

Our strategy in structuring the Fund as follows:

- **Laddered Approach**
  - ~70% of the Fund will be laddered in bonds maturing five years or under, while the remaining 30% of the Fund is invested in areas along the curve where we believe that there is a value to take advantage of mispriced areas of the credit or interest rate curves.
- **Bias to Corporate Bonds**
  - Since the majority of the Fund is shorter dated, the value lies in one- to five-year corporates where average spread premiums over government bonds are in excess of 100%.

How Do Savers Save in Fixed Income? *Cont'd*

- In all interest rate scenarios (rising, declining, or stable rate environment), corporate bonds typically outperform because of the amount of spread premium it provides and its short time frame to maturity.

- **Use of High Yield, Convertible, Preferred Shares to Generate More Yield**
  - The strategy is to hold high-yield bonds that have average ratings of B- and above.
  - High-yield and convertible bonds we will be targeting maturities of five years or under.
  - We will be selective in preferred shares with the anticipation that increase rates will rise at some point in the future.

- **Short Selling Securities**
  - This tool in our toolbox is intended to help us mitigate downside risk rather than to use it to generate alpha. The strategy with shorting is around mitigating interest rate risk and shorting longer-dated government bonds (if exposed) as volatility is more pronounced in that part of the curve.

- **Use of Leverage**
  - The use of leverage is to help facilitate inflows and outflows from the Fund without negatively impacting the returns of the Fund.

We have capped the leverage use to 20% of the Fund.

- **Investing in Other Markets**
  - We are selective in investing in other geographic areas and look for investments that present better value than in the Canadian bond markets (whether from an issuer or sector diversification perspective). We will be hedging the currency to reduce foreign currency exposure.

Risks to Investing in the Fund:

1. Interest Rate Risk

- **MITIGANTS:**
  - The strategy is to position such that we are short duration (ie. sensitivity to an increase to interest rates is lessened). In addition, when investing in long-end corporate bonds, we have the ability to short sell long-dated Government of Canada bonds to mitigate interest rate risk.

2. Credit Risk

- **MITIGANTS:**
  - We are selective in the companies we invest in and perform our own due diligence.
  - We hold a diversified portfolio with no more than 10% exposure to any one corporate issuer.
  - High-yield is capped at 40% of the Fund. Our strategy is to be targeting a 25% holding in high-yield. In addition, we will be targeting to invest in shorter-dated (five years and under) and higher-rated high-yield bonds (average rating for high-yield bonds are rated B low and above). Similarly, with convertible debt (and preferred shares) are capped at 20% of the Fund. Our strategy is to invest in convertible debentures that are generally five years and under.

3. Reinvestment Risk

- **MITIGANTS:**
  - We have laddered the portfolio such that maturities are spread in a way that we are not exposed to any one maturity time frame.
  - In addition, we are actively managing the portfolio such that we will extend maturities just prior to final maturity dates if there is an opportunity to do so.

Upcoming US Election and the Market

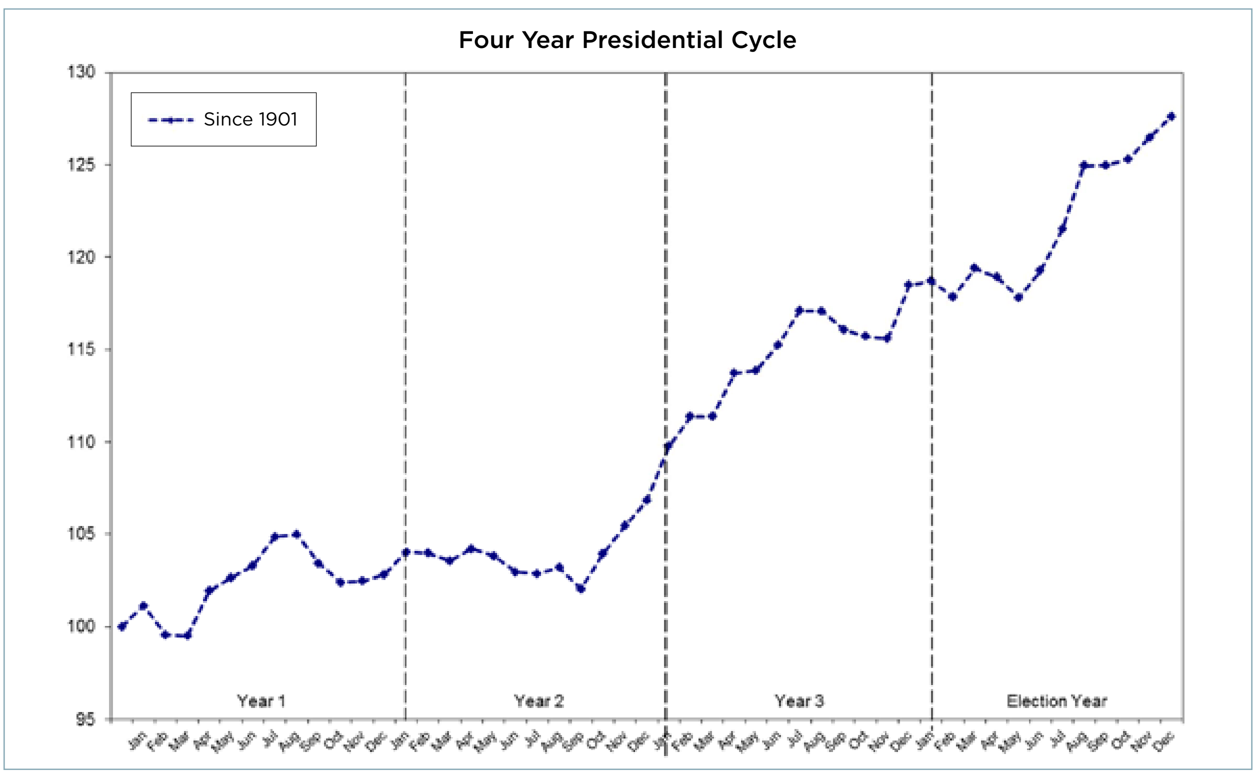
Darrin Erickson, MBA, CFA, Portfolio Manager

Election antics are heating up and even in Canada you would have to go somewhere pretty remote to be shielded from the non-stop barrage of US election coverage.

Although the coming election on November 8th promises to be particularly entertaining, many people both north and south of the border (if not globally) are justifiably concerned about how the election could impact their investment portfolios.

The good news is that while elections in the US tend to be dramatic affairs, they almost always have a happy ending when it comes to the equity markets.

In the below chart, market returns since 1901 are broken out by each year of the presidential cycle. You can see that although election years can start off slow, markets do tend to perform well in the last quarter of the year. The reason is simple – investors



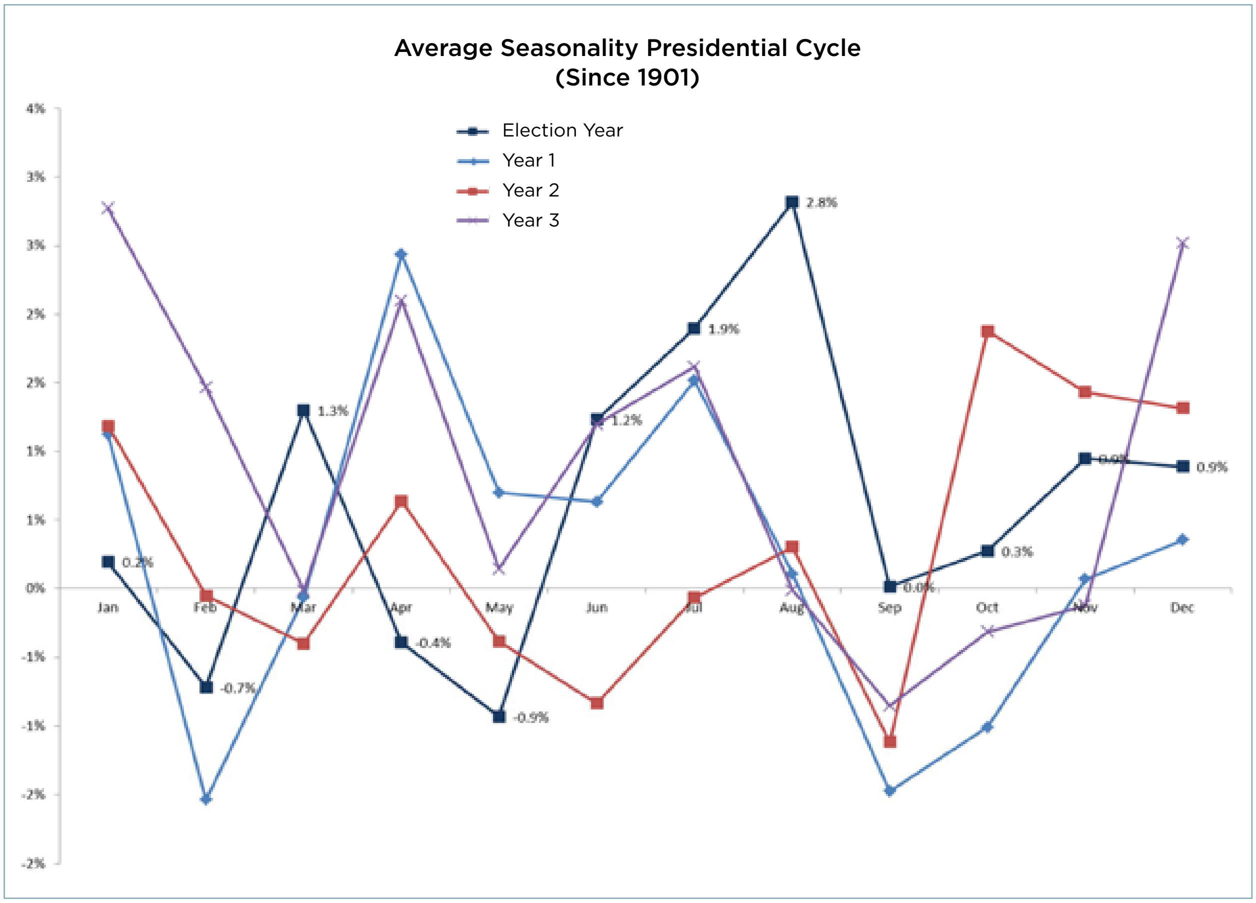
Source: Renaissance Macro Research

Upcoming US Election and the Market *Cont'd*

dislike uncertainty and as the election date nears, polls provide increasingly clear indications as to who will prevail. At that point, investors again become comfortable investing in the US market.

This is also evident in the chart below, which shows the average monthly seasonality for each year in the election cycle. In this case September tends to be a weaker month, but is followed by strong performance beginning in October. Therefore, any weakness experienced in the next month will be used to add to long positions.

Although the uncertainty that has weighed on the market fades as we approach the election, other industry-specific concerns arise. These are the



Source: Renaissance Macro Research

result of the President-elect's policy agenda, and are a much greater concern to investors. Here is where the "rubber hits the road" and multi-year investment themes can emerge.

Renaissance Macro's outlook on expected policy implications for the upcoming election are detailed in the table below. Please note that Chris Bolton's energy piece better reflects our firm-specific outlook on oil and natural gas. Keep in mind that Renaissance's commentary speaks to contributing factors, not definitive outcomes. RenMac speaks to political implications, which can differ from supply/demand fundamentals of any good or service.

Regardless of who wins the election, interest rates are expected to slowly increase.

Upcoming US Election and the Market *Cont'd*

This should continue to drive demand for US bonds and support the US dollar. This will also benefit US banks and insurance companies. It is also expected that infrastructure spending will increase, and that defense contractors will also do well as both candidates (particularly Trump) intend on continuing or even intensifying the battle against terrorism. That being said, investors are already becoming increasingly confident that Clinton will win the election, especially after the first presidential debate. While it appears unlikely that Trump can win the election, it would certainly cause volatility in the

Subject/Sector	Topic(s)	Driver(s)
Macroeconomics	1. Normalization 2. Fed audit	Nearly 10 years of extraordinary policy
Fiscal	* Infrastructure * Entitlements * Taxes	* Boost confidence to spur capex * Remove LT debt worries from market * Address stagnation
Trade	* TPP and TTIP * Tariffs	* Trade negative feature of campaign on both sides * Deals overall positives for US economy and soft power; trade war not
Geopolitics National	* Mideast * Europe * China	* Growth (or lack thereof) * Diplomatic/military initiative to reset boundaries & norms
Security	* War-fighting	Transnational terror
TMT	* Net Neutrality	3rd time a charm for FCC; appeals or reform legislation unlikely
Financials	* Fintech * Systemic risk	Regulation (likely but not soon)
Healthcare	* Pharma * Obamacare * Zika	Medicare cost constraints
Energy	*US energy mix (traditional vs. renewables)	* Industry & market dynamics and pricing * Climate awareness * Gov't. balance * Infrastructure
Housing	*GSEs	$1.2B slim capital buffers gone by 2018

Source: Renaissance Macro Research

Upcoming US Election and the Market *Cont'd*

markets in the short term if he did win. In terms of industry-specific policies, Clinton has made it clear that she wants to target pharmaceutical and biotech companies that charge "excessive" prices for drugs. As we near the election, Perron and Partners will continue to monitor poll results and the policy agenda of both candidates in order to anticipate the final impact on the equity and fixed income markets. Rest assured that we will be proactive in protecting client wealth in addition to taking advantage of any growth opportunities that ultimately emerge from the election.

	Outlook	Implication(s)
	1. Data support rate increases 2. Coalition against threats to independence strong	+ US bonds (safe haven > rate outlook)
	* Surest revenue boost via econ growth, not rate increases * Omnibus or smaller bills a greater uncertainty than pressures for a 2017 economic program * Medicare most urgent deficit spending pressure	+ Growth stocks + Dollar
	* Was TPA the high-water mark? * 2016 TPP enactment helps TTIP in 2017 and a 2018 UK bilateral; converse clouds outlook	+ US multinationals - Gold
	Absence of concerted action causes either stagnation or erosion of apparent and emergent issues	Positive growth / lower GPR scenario: + US stocks - US bonds + EM bonds & stocks
	Overseas Contingency Operations account enjoys bipartisan support	+ US & EU defense stocks
	Executive and Judiciary end up in edge/OTT providers; incumbents adapting	+ TMT stalwart stocks + Tech manufacturer stocks
	* Eventually broader nonbank risk rules cover space * US banks best of global lot due to recovery and risk mitigation	~ Fintech + US universal banks
	* Costs constraints essential to federal debt stabilization impossible * Pharma margins dented by regulation, legislation, or negotiation * Zika picture data- and politics- dependent	+ ACOs, epidemic fighters, and responsible pharma look good
	* Green tax breaks protected but not invincible * Hydrocarbons retain voice and place in the mix for both federal and state policymaking	+ We generally like natural gas (and LNG), demographic plays, and midstream ~ Other plays largely dependent on policy outcomes and individual company financials to monetize and nurture policy
	Guarantee function unique, crucial, and likely protected by 2017 action	+ FNMA/FMCC common stocks

Energy Musings

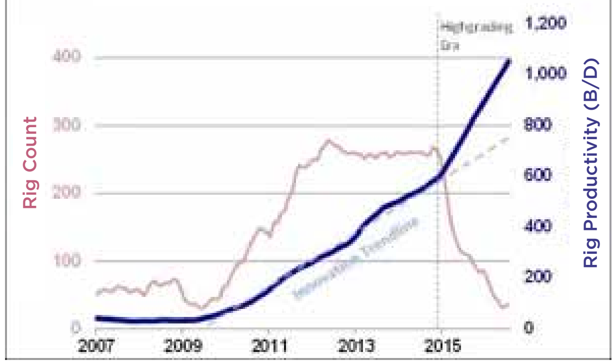
Chris Bolton, CFA, Portfolio Manager

Below are a few topical issues that resulted from attending Enercom's 21st conference in Denver in August:

1. Natural Gas Optimism

Anecdotally, there was more optimism around natural gas prices than last year. Many attendees pointed to a decline in the natural gas rig count and a decline in associated gas production from fewer oil wells in production leading to lower supply. In addition, Cheniere Energy, Inc. began to export liquefied natural gas from the US Gulf Coast in February, and other projects are currently in various stages of development.

Figure 1: Eagle Ford Rig Productivity
Monthly; Jan 2007 to July 2016



Source: National Post, EIA, ARC Financial

Our outlook is more tepid. Firstly, we would note that while the number of rigs has declined, the productivity of those rigs has increased significantly. The following chart highlights the productivity of rigs in the Eagle Ford area in the US. While the number of rigs has declined from over 250 a few years ago to less than 50 today, the productivity of these rigs has gone up substantially. According to data from the Energy Information Administration (EIA), production per rig has increased from less than 100 boe/d (barrels of oil per day) in 2009 to over 1,000 boe/d today. Consequently, we do not think rig count is the best measure for forecasting supply (unless you are adjusting for current rig productivity).

Secondly, natural gas in storage in the US remains above last year's levels and above the five-year average. On August 25th, the EIA released its Natural Gas Storage Report for the week ended August 19th. Total working natural gas in storage was 3,350 billion cubic feet (Bcf), 275 Bcf above last year's 3,075 Bcf and 350 Bcf above the five-year average of 3,000 Bcf.

Energy Musings *Cont'd*

Thirdly, a lot of natural gas stock prices have increased substantially in recent months. For example, in the six months ended August 25th, 2016, the BMO Junior Gas Index ETF increased in value by over 52%.

Natural gas prices have historically been highly influenced by weather.

Hot weather in the summer months typically leads to increased power demand to run air conditioning, and natural gas is often used as the fuel source for "peaking" power plants. Cold weather in the winter months typically leads to increased demand for natural gas as a heating fuel. We are not aware of anyone being able to consistently predict long-term weather patterns with accuracy. Consequently, we would note that forecasting natural gas prices remains difficult. However, with the stock prices having increased substantially since the spring, we believe there is downside risk if storage levels remain high and the winter is warm.

2. Advancement in Technology

Technology and innovation continues within the industry. Companies continue to experiment with different sand types and completion techniques. Many companies are now focusing on drilling two-mile laterals on their wells. Advances in drilling and completion technologies appear to make these wells much more successful than in the past. The result is typically superior economics to drilling two one-mile wells.

On a micro level, advances in technology will likely continue to yield lower drilling, completion and finding and development costs on a per boe basis. However, on a macro level, technological advances likely mean companies can drill and be profitable at lower commodity prices. Consequently, new supply may come on at lower prices than in the recent past and this may result in lower commodity prices for the industry as a whole as the marginal cost curve moves downward.

3. Mexico

Haynes and Boone, LLP sponsored a presentation on Mexico's oil and gas industry. The potential in Mexico is substantial. However, there are numerous challenges converting an industry that has effectively been a government monopoly for 70 years to the type of free market industry we enjoy in Canada and US

We at Perron & Partners will continue to monitor the situation in Mexico with great interest.

4. New Regulations

There are two ballot initiatives (75 and 78) in Colorado that would put more restrictions on oil and gas companies within the state. If approved, initiative 75 would grant local governments the authority to regulate oil and gas development within their geographic borders. Initiative 78 would require that all new oil and gas development facilities must be at least 2,500 feet from an occupied structure. To get on the ballot, proponents need to submit 98,492 valid voter signatures (5% of the total votes cast for all candidates for Colorado secretary of state in the last general election). Proponents of the two initiatives submitted what they claim are sufficient signatures on August 9th. On August

Energy Musings *Cont'd*

29th, Colorado's Secretary of State announced that "Supporters [of the two ballot initiatives] didn't collect enough valid voter signatures." According to the Secretary of State, "Supporters of the two measures collected more than that [98,492 signatures] for each proposal, but not enough to compensate for the number of signatures that were rejected during the random sample." The Secretary of State reported that for initiative 78, the petition processing team identified a petition section that contains several potentially forged signature lines and has referred the matter to Colorado's Attorney General. Proponents have 30 days from August 29th to appeal the decision to the Denver District Court.

5. Russia

The Honorary Russian Consulate of Denver (Dr. Deb Palmieri) gave a presentation on Russia. She believes that the Russian economy is much stronger than the Western media would have you believe.

In her opinion, Russia sees the "Orange Revolution" in Ukraine as being backed by the US and sufficient justification for Russian activities in Crimea.

She also believes that the expansion of NATO irritates the Russian government and that sanctions against Russia from the West have only deepened the relationship between Russia and countries such as China.

Overall, the conference represented an opportunity to see the senior management of existing investments as well as see other new ideas. An update on political and regulatory changes also highlights risks and opportunities.

When investing your capital in the Energy sector, we want to make sure we buy the very best companies available (regardless of geography).

What Is an FEA?

Shawnalynn Perron, MBA, CIM, FEA, Portfolio Manager

In May, Shawna successfully completed the Family Enterprise Advisor program & received the designation of FEA. To introduce this to our clients, we asked her the following questions to further explain:

Q) I have heard of a CFA and a CFP, but what is an FEA?

FEA stands for Family Enterprise Advisor. Individuals who have completed the FEA program receive the designation from the Institute of Family Enterprise Advisors, the founding educational partner being the Sauder School of Business.

The program focuses on teaching professionals from a multitude of backgrounds an approach to learn and integrate their knowledge with others, in order to collectively provide the best platform of collaborative advice for wealthy families and for families in business.

Q) What are some examples of when working with an FEA is of value to individuals or families?

Major life events that will impact more than one generation are perfect examples. Estate planning, shared asset management agreements, marriages, death, the purchase or sale of the family business or significant assets are just a few examples. Life moments like these bring a family together, and its members are impacted by decisions made, agreements or lack of agreements in place, and most importantly the longevity of the family wealth/enterprise.

History will tell you that one generation will spend their lives building the wealth and the next will consume it.

So, how can we prevent this from happening? Working with someone who has been trained and earned an FEA designation, with experience working with families with various needs, can greatly impact the health and strength of a family, and the ability of future generations to continue to build and add value to the family enterprise.

Have you discussed your will or estate plan with your children?

Do they know your plans? Have your children ever had to work together before to manage a family asset? If the answer to these questions is a NO, working with someone who has an FEA designation would be a great start to having these conversations.

What Is an FEA? *Cont'd*

Q) When did you realize that you wanted to complete the FEA program?

After several years of working in the investment management industry, I continually felt there was more we could offer our families. At first, I had a hard time identifying what it was until one day it all clicked. An older gentleman and I were having a casual conversation when he said to me, "I have three children that have no idea how much money and shared assets they will come into when I pass and it worries me that they will waste it, spend it ruthlessly, and that it will tear them apart. My family is so important to me and I would hate to see it create separation and anger. I have no idea how to communicate to them or educate them on what they need to do." I felt helpless. Then, I started thinking about my own family and my four siblings. It would be awful for money to destroy our close relationships. So, I started searching for answers and quickly came across the FEA program and knew that I had to complete it. It has laid the foundation of knowledge that I was desperately seeking. I knew after completing this, I wanted to help families proactively navigate this process so that money does not create separation and disagreements but instead brings everyone together in a way that is intriguing, thoughtful and achievable.

Q) What is involved in achieving an FEA certificate?

The designation is a one-year program with seven two- to three-day in-class sessions focused on the following topics: business family dynamics, family enterprise strategy, business boards and family councils, multi-disciplinary advising, facilitation and communication skills, continuity planning and knowledge integration and application.

Each session helps bring together the strengths of working with a multi-disciplinary team to better serve our family clients. It concludes with a project working alongside a family in need of comprehensive advice.

It incorporates extensive information gathering, collaboration, presentations, recommendations and feedback. In order to receive and earn the designation, you are then tested on your knowledge with a timed online and in-person examination.

Q) What is the process to get started, and what is involved?

A discovery meeting over a latte about family and desired goals is an excellent starting point. We would then draft up a contract to outline the process to achieve these goals. Following this, members of the family and other related individuals would be interviewed to understand the different perspectives and personalities that make up the family. Initial analysis and feedback would be given and recommendations would be outlined. Implementation and following through then becomes the main focus for the family and the advisor.

It is common for families to feel overwhelmed by the process because of all the different angles that could arise, especially if there are deep-rooted issues already brewing. However, we would take it one step at a time before leaping in with both feet. Little successes along the way make for greater and more accepted outcomes.

Our goals are the same: family health, family happiness and family togetherness.

*If you are wondering if this program would be a fit for your family, please feel free to call with questions.

Kipling Private Investment Portfolios Name Changes

Effective October 1st, Kipling Private Investment Portfolios will change the names of the following Pools:

- Kipling Canadian Enhanced Income Pool –
  NEW NAME Kipling Canadian Enhanced Dividend Pool
- Kipling US Enhanced Growth & Income Pool –
  NEW NAME Kipling US Enhanced Equity Pool
- Kipling North American Enhanced Dividend Pool –
  NEW NAME Kipling Global Enhanced Dividend Pool

While none of the above Pools will change from an investment standpoint, it is anticipated that the new names will provide additional clarity to shareholders and investment partners as to the focus and purpose of each of the individual Pools. Specifically, within the context of the broader asset mix structure offered through the existing suite of Kipling Private Investment Portfolios. For reference, the Kipling Private Investment Portfolios will continue to offer the following investment strategies;

- Fixed Income (CDN & US)
- Global Balanced
- CDN Equity
- US Equity
- Global Equity

Not only is the regional equity exposure explicitly stated, but overarching equity philosophy is as well. Specially, the increased emphasis on dividend-paying equities for two of the above strategies reflects the important contribution dividend yield has made to stock market performance. We believe that dividends provide an objective measure of value independent of accounting methods and management judgment, and that paying dividends instils some level of capital discipline. This also indicates that management is focused on returning value to shareholders. In our opinion, dividend-yielding equities will continue to be attractive given an aging demographic, a strong appetite for yield and low government bond yields.

Short Selling within the Context of Portfolio Management

Derek VanGenderen, Equity Analyst
Jason Isaac, CFA, CAIA, Portfolio Manager

Readers know we are committed to our "enhanced" investment portfolios. The risk/reward metrics stack up favourably versus long-only portfolios and over reasonably longer investment horizons (say three to five years) this strategy exhibits reduced portfolio volatility and smaller declines in value (i.e. drawdowns) while achieving similar returns.

A portfolio which includes both long and short positions in stocks, which tend to move together, will generally have lower volatility than one which has only long positions, because the outcome of shorting is that in periods of declining market prices the active short portion of the portfolio tends to preserve the gains or trump the losses we see on the long side of the book. What we are attempting to do in this article is provide our readers a high level review of our process as we search for shorts to include in our portfolios.

Successfully shorting securities in the stock market is challenging, since the path of least resistance tends to be up. Many aspects of short research mirror the principles of long portfolios, but with a different tilt. The key to finding ideas from the opportunities universe is to focus around the firm's business model and the underlying drivers employed in an attempt to create returns for shareholders.

The entire universe of stocks can be narrowed down to three key areas short sellers can zero in on, helping them find possible ideas. Our short selling process focuses around 'the three Fs': fads, falters, and fabrications.

Our short selling process focuses around the three Fs: fads, falters, and fabrications.

Fads are some of the easiest to identify, but can also be the most harrowing to short, as they ride a wave of momentum on the back of a business with very few competitive advantages. Fads are most typically found in market segments including restaurant concepts, fashion brands and consumer electronics. These companies typically lack the competitive advantages necessary to create an enduring business model. Fads come fast out of the gate and have no stamina to win the marathon.

Falters are more difficult to find, as you have to dig deep below the surface for details. For example, on the surface most of the large automotive OEMs (make input for cars) have posted record profits over the past year, which appears great. However, digging deeper you will find an inventory build inside the supply chain in terms of day sales outstanding and from dealership executive comments. One specific public dealership group had stated that

Short Selling within the Context of Portfolio Management *Cont'd*

in order to move cars, the sales incentives have shifted from 2-3% closer to 8-10%. The margins and profits are always best at peak, but a down cycle in the automotive business is vicious due to high fixed costs and companies' profit margins often getting cut in half. Other faltering areas are highly levered, deteriorating competitive advantages, and macro-economic downsides.

Fabricators are by far the most difficult to find, requiring the most work and typically come as a by-product of faltering businesses encompassing aspects of a fad. Chicanery is typically used to try and keep the game going for a little bit longer in the hopes of turning the business around. The most common manifestation of this is in the accounting shenanigans utilized by acquisition-focused companies. Typically these firms utilize their exorbitant multiples in the market to acquire cheap low-quality businesses to juice earnings, adding very little economic value to the firm over a multiyear period. Normally these companies are the most egregious offenders when it comes to using "adjusted" numbers. You consistently see anomalies show across the balance sheet in terms of discrepancies in receivables relative to sales, restructuring charges, inventory levels, and their organic incremental return on capital. These firms typically rise on the income statement and crash on the balance sheet.

But short selling is not as easy and profitable as it may sound; there are a lot of caveats. As we mentioned, there's unlimited downside potential (i.e. if the stock price keeps rising, you keep losing). Most short sellers set a limit to how much they're willing to lose, but then they become vulnerable to a short 'squeeze', in which long investors buy shares as the stock rises and demand delivery. As short sellers buy to cover their losses, the price continues to rise, triggering more short sellers to cover their losses. This is a risk especially for small, illiquid companies. The danger is that even if the stock is overpriced, it may become even more overpriced, and you will have to buy it at some point to cover your position. When you sell short, you're not just betting on what the stock is worth, you're betting on what the market will be willing to pay for the stock in the future.

Ultimately, we include shorts in our portfolios because we believe it is the most prudent way to manage a portfolio, from a risk perspective.

While you may have found a great idea to short, today may not be the best day to step into the position. Shorting Crocs at ~$13 during mid-2006 would have resulted in your losing nearly $56 on your investment before earning almost $10 after the crash in 2009. While you can be ultimately right, there is potential to be so wrong in the interim that you cannot stay on the short. This risk is managed internally by portfolio construction consisting of exposure management, position sizing, security liquidity, and borrowing costs associated with each position. While being long health care and short oil and gas may allow for a greater total return over a yearly time period, you are taking on extremely high risks with both large sector allocations and security selection miss-matches within the portfolio, leaving you very exposed to significant losses.

Our firm's stance on short selling is to augment and improve the alpha generated by managing long and short positions inside each sector.

It is not to take excessive risk. The ability to generate with both long and short books allows us to keep sector exposures and tracking error smaller, while still allowing for the opportunity to generate significant alpha through a higher gross exposure.

When you short, it's important to have the right benchmark. People look back and say, "I spent all this time and effort on shorting and only broke

Short Selling within the context of Portfolio Management *Cont'd*

even – what a waste of time." We compare how our shorts have done against the market. If we've broken even on our shorts over a period where the market is up 7-8% per year, we've generated huge alpha that has allowed us to be levered to our longs.

We would call that a zero-cost hedge and a very valuable tool.

When there is a cyclone of wealth transfer into an area, some of the participants in the fledgling industry will be real companies whose products and services will change the world. But there will also be dozens of other bogus companies run by unscrupulous promoters. That's the subset of the market we're attracted to on the short side.

On the short side is to see things start to break down before we get involved. Once something starts to crack, there will still likely be plenty of disagreement – reflected in the stock price – on whether or not the business is really broken. So we'll typically miss the top, but the risk/reward can look even better to us long after the break. Interestingly too, we won't short on valuation – say, because Google is trading at 20x next year's cash flow when we think it should only trade at 15x.

One challenge we've had in shorting is with growing, but grossly overvalued companies, in which the market can delude itself for a long time. We gave up on our short of solar energy company First Solar [FSLR], for example, after analysts started doing things like setting a price target and then backing into the multiple at which they thought it should trade today.

Our experience with our quantitative models indicates that following a period of underperformance, investors can expect to reap above-average returns from our quantitative models.

Once again, the quantitative approach will not work every year and in every type of market, but if you stick with the program over the long run we believe your chances of success are high.

*Recap on shorting: Ideally when shorting, you sell a company you don't own by borrowing it (anticipating that it will drop) and then replace in the future by purchasing at the lower price.

Factor Analysis

Jason Isaac, CFA, CAIA, Portfolio Manager

Factor investing requires investors to take into account an increased level of granularity when choosing securities. More specifically, this is an additional investment step beyond the traditional asset mix decision.

Typically, a factor can be thought of as any attribute relating to a group of securities which is fundamental in explaining their return and risk characteristics. Research has shown that certain investment factors tend behave in different ways depending upon the macroeconomic environment at hand. At the highest level, these factors represent specific exposures to the various sources of systematic risk in the marketplace. As an investment strategy, factor investing attempts to capitalize on the transitory risk premia by manipulating the exposure to various factors in the portfolio.

Commonly, many industry practitioners and academics identify six areas where a conscious investment decisions can be made as to what type of factor the investor wants to be exposed to.

Systematic Factors	What It is	Commonly Captured by
Value	Captures excess returns to stocks that have low prices relative to their fundamental value	Book to price, earnings to price, book value, sales, earnings, cash earnings, net profit, dividends, cash flow
Low Size (Small Cap)	Captures excess returns of smaller firms (by market capitalization) relative to their larger counterparts	Market capitalization (full or free float)
Momentum	Reflects excess returns to stocks with stronger past performance	Relative returns (3-mth, 6-mth, 12-mth, sometimes with last 1 mth excluded), historical alpha
Low Volatility	Captures excess returns to stocks with lower than average volatility, beta, and/or idiosyncratic risk	Standard deviation (1-yr, 2-yrs, 3-yrs), Downside standard deviation, standard deviation of idiosyncratic returns, Beta
Dividend Yield	Captures excess returns to stocks that have higher-than-average dividend yields	Dividend yield
Quality	Captures excess returns to stocks that are characterized by low debt, stable earnings growth, and other "quality" metrics	ROE, earnings stability, dividend growth stability, strength of balance sheet, financial leverage, accounting policies, strength of management, accruals, cash flows

**MSCI Research Insight, Foundations of Factor Investing (Dec 2013)*

Factor Analysis *Cont'd*

Over any relatively short time frame (say three to six months) factor performance will be influenced by market conditions. Reading quickly over the following Morgan Stanley US Factor performance chart, we note some of the macro trends that influenced factor performance during the first eight months of the year:

As can be seen, the traditional client-friendly investment factors that many portfolios are tilted towards lagged the market in 2016. Namely,

- Large Mkt Cap
- High Share Buybacks
- Low P/E
- High ROE
- High Dividend Growth
- Free Cash Flow Growth

Conversely, many of the more aggressive, risk tolerant factors that tend not to be prudent for the bulk of private client portfolios were among the top performers.

Specifically,

- Mid-Cap
- High Dividend (high payout ratios)
- Low ROE (poor profitability)
- Low Quality (high leverage/debt)

Some of the macro trends were:

Sovereign yields fell sharply as investors were disappointed over the pace of global economic growth, concerned about the health of European banks, and positioned for the risks of Brexit.

This befitted high dividend payers as they offer competitive yields, but with a tilt towards company's high payout ratios and uncertainty about the prospects over raising the dividend.

Mid-cap value's performance was lifted by its relative overweight to real estate, energy and utilities. Real estate investment trusts (REITs) and utilities were supported by the drop in interest rates, while the oil price rally in the second quarter greatly benefitted mid-cap energy shares.

The Buyback, ROE, Dividend Growth and Quality factors all lagged primarily due to lack of exposure to the Energy and Materials sectors. The reality is that very few of the companies were in the in the position to be buying back shares or increasing dividends. In fact, most were issuing new equity and slashing the dividend just to stay afloat.

Factor Implications Going Forward

Politics The global markets face uncertainty over the impact of Brexit and what exactly the European Union and European Monetary Union will eventually look like. Moreover, as the US election heats up and sound bites are digested by the markets as pending policy markets are likely to see increased uncertainties and this will highlight risk mitigation strategies such as low volatility, enhanced portfolios and dividend growth.

Factor Analysis *Cont'd*

QDS Intraday US Factor Analysis
US Factor Performance: August 31, 2016

MSCI USA
Cumulative Performance (%)

Factors	Style	LTM	YTD	MTD	WTD	Aug 31
Trailing Earnings/Price	Value	0.24	-6.48	1.90	1.02	0.05
Book/Price	Value	2.27	8.65	0.48	0.88	0.00
Cash Searnings/Price	Value	1.79	2.25	1.90	1.03	0.13
Sales/Price	Value	0.03	7.31	2.12	1.05	0.39
Dividend Yield	Value	11.75	9.17	1.55	0.28	0.02
ROE	Quantity	-2.57	-8.95	0.49	0.04	0.12
Est. Long-Term Growth	Growth	-8.05	-10.55	-1.74	-0.36	0.12
1-Yr Est. EPS Growth	Growth	-6.96	-6.03	-1.88	-0.33	0.16
3-Mth Hist. DPS growth	Growth	-2.26	-2.41	1.39	0.05	0.24
FCF/Sales	Cash Flow	1.49	-6.34	0.02	0.30	0.18
FCF/Price	Cash Flow	0.46	-4.41	1.76	0.86	0.09
1-Mth Price Momentum	Momentum	-5.76	-0.70	0.53	0.17	0.37
6-Mth Price Momentum	Momentum	-1.20	-7.24	-2.21	-0.79	-0.09
Size (Mkt Cap)	Size	3.32	-4.70	-0.06	-0.16	0.15
Debt/Equity	Leverage	-2.53	0.86	-1.41	-0.08	0.10
Debt/Assets	Leverage	-4.15	2.22	-0.46	0.10	0.10

Source: Morgan Stanley

In contrast, momentum will hurt by any "risk-on/risk-off" environment where investors become concerned about reactions to political risks and pay less attention on company fundamentals.

Monetary Bank of England (BOE) Governor Mark Carney suggested the BOE could cut interest rates if necessary, and the ECB suggested it is looking into loosening the rules around its bond purchases program due to a shortage of bonds related to Brexit, thereby supporting liquidity. The ECB's comments indicate a strong demand for high-quality debt. This

Factor Analysis *Cont'd*

reinforces the idea that investors will be hunting for yield, and this will no doubt be another element in favour of dividend-paying stocks.

Until there is a meaningful shift in the rate environment, dividend and low-volatility stocks are likely to remain a focus.

Value stocks, in contrast, face a significant headwind in a perennial low-rate environment due to their need for robust economic growth in order to outperform.

Economy At the 60,000-foot level, the economy is showing some signs of improvement, but has yet to display breakout growth. The headwind of inventory is still there, but some US currency stabilization is beginning to take pressure off the export sector, and has spurred renewed interest in the Emerging Markets. US Housing appears to be experiencing a slow-steady recovery, while unemployment claims remain low. There seems to be just enough growth to push profits forward, but at this point it's not enough to overcome the deflation fears in Japan and Europe. The value factor would be more likely to generate excess returns in a vibrant economic environment where interest rates are increasing.

After an aggressive bounce off the bottom of some of the more cyclical areas of the market, quality stocks strike a nice balance of being able to deliver profits in an environment of slow growth while being able to participate in accelerating economic activity if (or when) it develops.

Oil The International Energy Forum was held at the end of September in Algiers. Much to the surprise of almost everyone, OPEC has capped output to 32.5 million barrels a day. This represents a 900,000 barrel cut to production for them. This prolific announcement reverses the two years of pump-at-will policy and will most likely help set a floor for prices.

Given all that has happened last year with lower quality factor indicators collapsing, it is not surprising to see a minor reversal in relative performance. However, factor timing is just as difficult as timing the overall markets, so while the trend may reverse on you any given year it is better to stay focus invested in high-quality businesses and ride out the waves.

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