RICHARDSON GMP

Third Quarter 2013 Equity Trading Accountability Report

General Comments

On Wednesday, October 9th, please join me and Vice President Gareth Watson for an important discussion of the current financial markets. See page 6 for details.

Last quarter, markets fell twice - both April and June (with a strong rally in between). The second quarter ended with pressing investor fears that the multi-year federal stimulus of the economy would be reducing or ending. It seemed interest rates had bottomed and were likely going to rise going forward, possibly for years. It was uncertain as to how to invest in an economy without stimulus and with rising interest rates.

At the start of the third quarter, pessimism evaporated quickly. With generally low expectations, companies were able to post reasonable earnings. Experts believed the nearly 1% jump in short- to mid-term government bond yields was overdone – an overreaction to Federal Reserve comments. By September, a surprise decision was made not to reduce government stimulus at all. As a result, most stock markets grew by about 5% over the quarter, and even Canadian bonds managed to post a slight gain (although still sit at a net loss year-to-date).

How to Build a Portfolio

The best way to take advantage of the growth in stock markets is to use a disciplined approach to manage between 20 and 50 stocks. Research in financial journals supports this number because it is the point at which 90% of the risk that can be reduced by diversification is eliminated. According to these studies, adding additional stocks after 50 are already owned in a portfolio provides very little additional benefit.

At the other extreme, a portfolio of less than 15-20 stocks is considered risky. On average, individual securities change in value by over 13% per month on the Toronto Stock Exchange. When an additional position is added to a portfolio, and the two stocks aren't exactly the same (correlated), it reduces the volatility of the portfolio. Investors with less than 15-20 stocks need to withstand relatively large levels of monthly portfolio fluctuation. By about the 20th security in a portfolio, the additional benefit of adding more positions begins to provide a smaller and smaller benefit in reducing risk.

Another consideration besides reducing risk is maximizing return. Buying all stocks in the market ensures that one will not beat the market. It is like playing a game for a tie at best. And there are hundreds of averages of stocks when global markets are included. Which average is the market?

Having a few dozen stocks allows a portfolio to benefit from successful stock selection because the individual positions are large enough to make a difference. Yet at the same time, empirical evidence shows that 90% of the diversifiable risk has been eliminated.

In March of last year, Thomas Howard, Ph.D, wrote, "*Investors who avoid concentrated equity miss out on the <u>triple benefits of excess returns, lower risk, and lower correlations</u>. A portfolio concentrated in best-idea stocks has an excellent chance of generating excess returns. In turn, the cumulative excess return to investors lowers the risk of underperformance over time.*" Earning more money reduces the risk of not meeting long-term obligations.

Stock Picking Results

The third quarter results were fantastic. The average security held during the quarter made 9%. Eighty-seven percent of positions made money. Almost two-thirds of the selections beat both the Canadian and the U.S. stock markets (when the return is calculated in Canadian dollar terms). Forty-two percent of the securities made more than double the market returns and more than a 10% return for the quarter. I'll be the first to point out that I've had quarters where stock picking has not had impressive results.

I do not manage a pool, or mutual fund, but instead make individual decisions in all of my client accounts simultaneously. The ability to perform discretionary management across many families at the same time is a product of technology. Clients get the benefit of an individually customized portfolio, without the logistical complication of an advisor having to prioritize transactions in the order of successful discussion with each client. I have six equity models, but those models are applied differently to each family. Other unique positions, tax consequences, and circumstances are also considered. Portfolios are very similar; but proportions and occasionally positions are different.

Year-to-date, the equities in accounts I manage had a gain of *typically* 14-16%, while fixed income in isolation *typically* gained 2-5%. There is variance in results because portfolios are custom, but similar. Individual portfolio returns can be approximated by calculating the simple weighted average of these numbers depending on the amount of equity versus fixed income owned in each portfolio. This average portfolio result needs to be reduced because most accounts held cash at times during the year. I consciously reduced equity in portfolios this year during both April and June as a protective measure. In hindsight, I was wrong, fearing that markets could have dropped further at those times. This judgment slightly reduced year-to-date portfolio returns. However, I do consider risk-reduction a significant responsibility in managing portfolios and intend to continue to enact selling procedures when I believe a larger correction might be at play.

As a comparison, the Canadian market grew by over 5% year-to-date while the U.S. market rose by nearly 18%. The Canadian bond index lost 1.6% year-to-date. The Canadian Venture index dropped 23% year-to-date which may affect Canadian investors heavily involved in junior energy and mining. I would guess most Canadian investors have fixed income, Canadian equity, and possibly a minor exposure to the U.S., resulting in a very slight gain for the year.

One of the greatest sources of satisfaction for me as a Portfolio Manager is making money for my clients. I've been served a regular dose of humility in financial markets as an investment professional for nearly twenty years. My discipline doesn't win every period of time. I do expect it to work over the long run, and it is nice to celebrate when it happens to work exceptionally well. After being briefly pleased, it's time to deal with the next challenge, which currently seems to be the U.S. debt ceiling and potential government shutdown.

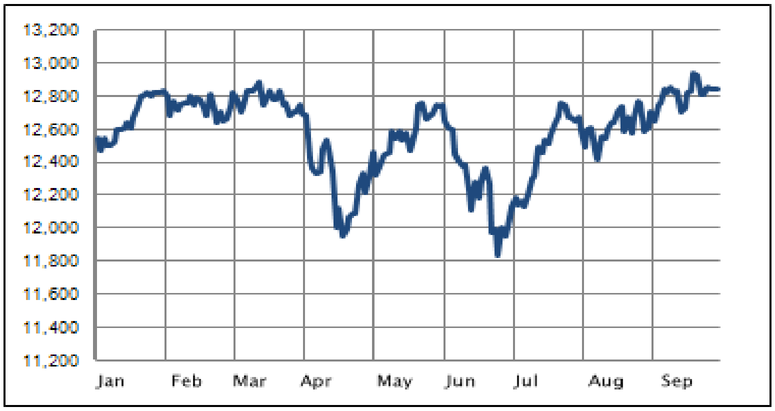
Fixed Income Results

The fixed income portfolios I manage made money this year compared to a loss for the bond index because they are composed of corporate bonds and not government bonds, and because they have a much shorter average term to maturity than the market index.

Corporate bonds have a slightly higher credit risk than government bonds. In return, investors get paid a higher yield (4-5% with the bonds I select on average, instead of 1-2% from typical Canadian government bonds and GICs). They do move inversely to interest rates like government bonds, but less so. If the reason for rates rising is a stronger economy, then corporate bond prices can actually appreciate. Convertible debentures are also owned which can participate in stock growth. Preferred shares, particularly rate-reset preferred, also round out a good strategy, although year-to-date this group has had a greater loss than the bond index.

Market Expectations

Canadian S&P/TSX Composite Index



Source: ThomsonOne

U.S. S&P 500 Composite

Source: ThomsonOne

The Canadian Market peaked in the spring of 2011, about 12% higher than the current level. There has been very little net gain over two years, and unfortunately minor panics along the way.

Going forward, the Canadian market may continue underperforming global markets. Should world economies finally move to late stages of economic growth, Canada's resource heavy market could actually begin to outperform.

The U.S. has been one of the strongest performing markets for the last two years, posting substantial gains. It is at all-time highs. I expect this market to continue to be strong, but perhaps at a slower pace.

The European recovery is about a year behind the U.S., and the Japanese recovery is further behind that. I expect some rotation to these other global markets as well.

Portfolio Strategy

Less fixed income than target levels is held in portfolios. Rates are low and the greater risk that bond prices move down as interest rates rise make fixed income less attractive.

Cash is mostly invested in equities. Cutting profits too early is a common mistake made by jittery investors. The recovery period since 2009 has been fairly long, and so the trend could change from positive to negative at any time. But so far it hasn't.

Consumer Discretionary and Heath sectors continue to show leadership, and form a large part of the equities selected. Not only do securities in these sectors screen well on my models from a profitability standpoint, investors are disproportionately buying these sectors compared to other ones.

Late cycle sectors such as industrial, materials and energy are very underweight in current portfolios. One reason I expect stock markets to continue to grow is that in a normal business cycle, growth in highly cyclical stocks usually marks the peak of the cycle. This hasn't happened yet. I am watching for it though and do expect to participate in securities that benefit from the final growth stage of the business cycle.

Defensive and recessionary sectors such as consumer staples and utilities are also underweight in the portfolio. Money flow is below average into these groups suggesting the likelihood that an overall market peak is not imminent, or at least not of concern to enough investors at this time.

An interesting early recovery sector that seems to be showing strength is the financial sector. It is likely that more commitment in the portfolios I manage will be made to stocks in this group.

Summary of Third Quarter 2013 Equity Trading Activity

Security	Curr	6/30/2013 Value	Buys Date	Buys Price	Sells Date	Sells Price	9/30/2013 Value	3rd Quarter Dividends	Total Return
Core Holdings									
Celgene Corp	U	116.98					154.14		32%
Mylan Inc	U	31.03					38.17		23%
Apple Inc	U	396.53					476.75	3.050	21%
Priceline.Com Inc		826.67	8/30/2013	937.90			1,010.95		19%
Waddell & Reed Fncl Inc Cl A	U	43.50					51.48	0.280	19%
Valeant Pharmaceuticals		90.68					107.40		18%
St Jude Med Inc	U	45.63					53.64	0.250	18%
TJX Co		50.06					56.64	0.145	13%
Platinum Group Metals Ltd		0.92					1.04		13%
Ishares MSCI Belgium ETF	U	13.62					15.39		13%
Ross Stores Inc	U	64.81					72.80	0.170	13%
Ishares MSCI Germany ETF	U	24.70	7/26/2013	26.30			27.81		11%
Black Diamond Grp Ltd		22.35					24.62	0.210	11%
Ntl Bk Of Cda			7/29/2013	78.80			85.07	0.875	9%
Rogers Communications B		41.20					44.29	0.435	9%
Open Text Corp		71.90					76.97	0.300	7%
Labrador Iron Ore Royalty		29.54					31.11	0.375	7%
Grt Wst Lifeco Inc		28.53					30.01	0.308	6%
Ishares MSCI Japan ETF	U	11.22					11.92		6%
Biogen Idec Inc	U		8/2/2013	226.95			240.76		6%
Tim Hortons		56.88					59.74	0.260	5%
Buckle Inc	U	52.02					54.05	0.200	4%
BCE Inc		43.12					44.02	0.583	3%
Bombardier Inc Cl B		4.68					4.79	0.025	3%
Constellation Sftwr Inc			9/20/2013	177.60			181.61		2%
Saputo Inc		48.34					48.87	0.230	2%
North West Co Inc		23.50	8/1/2013	24.20			23.57	0.280	1%
Green Mountain Coffee Roaster	U	75.22	8/1/2013	78.75			75.33		-1%
Shaw Communications B		25.24					23.98	0.085	-5%
Colgate Palmolive Co	U		8/1/2013	62.84			59.30		-6%
One Failed Trade									
Horizons Volatility S&P500 ETF		7.85			7/5/2013	6.75			-14%

Source: Richardson GMP as at September 30, 2013

Managed Account Equity Analysis

Analysis of Quarterly Trading

1. **It was a great quarter for stock picking.** The average gain was nearly double the market gain. Nearly every selection made money. Two-thirds of positions beat the market. This seems fantastic and we hope to do it again.
2. **Another positive was that profits were not cut short by selling.** There was a 5% market correction in August, but it was not sufficient to cause concern for any of the positions held, so there was no selling.
3. **The loss was closing out a failed trade initiated in mid-June.** It was positive that it was identified as losing money and eliminated. Today the price of that volatility note is 1/3 lower than the price sold at. However, there was a loss in the trade of the Horizon's Volatility ETF.

The Horizon Volatility ETF is a security that moves inversely to the direction of market. It was purchased in mid- to late-June as a response to the discussions by the Federal Reserve to begin removing bond purchases and stimulus from the financial markets. At that time, central bank discussions caused investors to push interest rates up and fear that markets might collapse if stimulus was removed.

The position in the Volatility ETF was intended to protect portfolios from markets falling as fears spread from the removal of federal stimulus. The panic turned out to be short-lived (rumblings and negative returns started in late May, but ended towards the end of June). I lost money in portfolios purchasing this protection because the market ended up rising rather than falling. Losing on buying protection meant that the market, and most positions held in the portfolio were rising.

I intend to continue with my portfolio risk management and protection strategy, despite the loss from doing it. When market weakness occurs, two things happen in portfolios I manage:

i. **Individual stocks are reduced or sold.** This happens when they drop significantly in ranking on my quantitative models; if they fail technical analysis that shows they have broken long-term support levels or deviate from their high more than normal; or a significant negative earnings surprise or revision is announced. Essentially the worst stocks go first. The goal is eliminate weaker positions and retain stronger ones.

ii. **Securities that move inversely to the market direction will be considered.** The security selected will have the greatest chance of reducing the loss in the markets affected the most by global weakness. The recent loss on this trade has shown me that volatility notes are too sensitive, and too difficult for me to successfully trade, so that specific instrument will not be used.

4. **Green Mountain Coffee Roaster is one of the largest positions in client portfolios.** It had a flat quarter, but is up significantly since originally purchased. At this time, it still ranks very well on my quantitative model, and would have to drop 17% from current levels for its long-term growth trend to be broken. Each stock has an individual tolerance level of how much decline would be considered normal in an upward trend.

5. **Green Mountain did nothing over three months. However, the four other of the largest five positions did.** Valeant grew 18%; Open Text by 9%; Priceline.com made 19%; and Celgene was the best overall performer, up 32%. An investor should diversify, but not enough to eliminate a good selection process.

Market Results

Index	Country	Third Quarter 2013	Nine Months 2013	2012
S&P/TSX Composite Total Return Index	Canada	6.2%	5.3%	7.2%
S&P/TSX Venture Composite Index	Canada	6.8%	-22.9%	-17.7%
S&P 500 Total Return Index	U.S.	4.7%	17.9%	13.0%
Nasdaq Composite Index	U.S.	10.8%	24.9%	12.9%
Euro Stoxx 50 Index	Europe	11.2%	9.8%	12.6%
Nikkei 225 Index	Japan	5.7%	39.1%	6.9%
MSCI Emerging Markets Index	E.M.	5.0%	-6.4%	12.2%
MSCI World Index	World	7.7%	15.3%	10.2%
DEX Bond Universe	Bonds	0.1%	-1.6%	3.6%
Canadian 3-Month T-Bill	Cash	0.3%	0.8%	0.5%

Source: Richardson GMP. All returns are in Canadian dollars as of September 30, 2013.

Seminar October 9th, 2013

Please join me in hosting Gareth Watson, Vice President, Investment Management Group, in an informative seminar outlining the current state of the global economy. Gareth develops and communicates Richardson GMP's core investment strategy to advisors and clients and provides insight into the markets.

Topics of discussion will include:

- Macroeconomic commentary on the United States, Europe, Japan, China and Canada
- Interest rate policy here and abroad
- The outlook for commodity prices going forward
- What the future holds for the Canadian dollar

Wednesday, October 9, 2013

Time: 11:45am – 1:00pm

Location: **Richardson GMP, Eighth Avenue Place**
Main Boardroom
Suite 4700, 525 8th Avenue SW

RSVP: Rita Penno by telephone 403.355.6034 or rita.penno@richardsongmp.com

Lunch and refreshments will be provided.

I hope you will be able to join us. Please pass this newsletter to anyone who may benefit from attending.

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