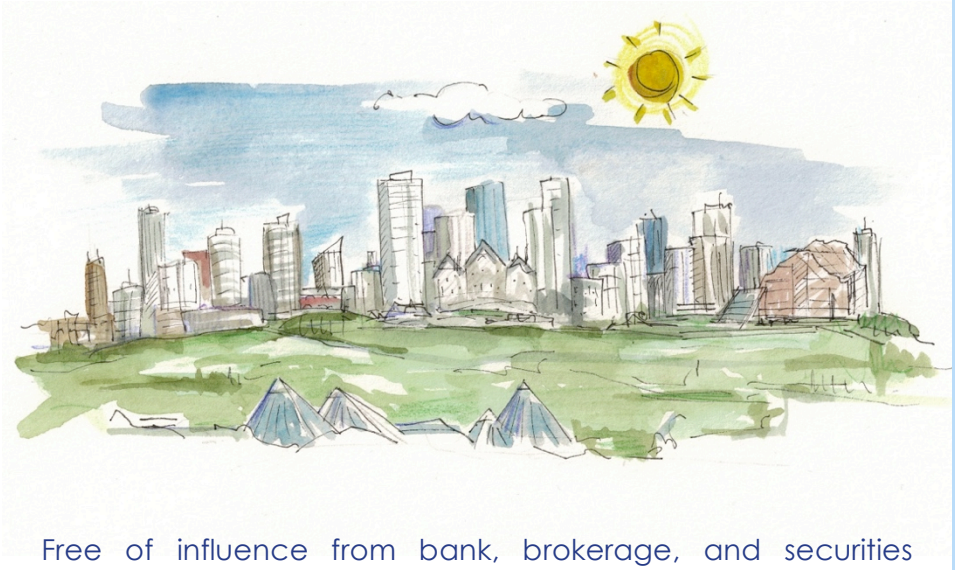
Qube Quarterly

2015: Q4

Poking the Bears?

Looking ahead to 2016.



Free of influence from bank, brokerage, and securities dealers, Qube is one of the few truly independent investment management firms in Western Canada. Our only agenda is to take care of you by managing and expanding your wealth.

We believe that when clients place their trust in a portfolio manager, they deserve a high level of transparency. By publishing this quarterly report, in conjunction with personalized account reviews, we want to give you insight into how we think about investing and what we are doing with your wealth.

Proper stewardship of your investments also means managing portfolio risk by incorporating responsible investing principles into all aspects of our work. Therefore, we continue to act on your behalf to demand the best from the companies that you own. More on this in my article on recent shareholder proposals later in this report!

Much can also be gained from tax and retirement modeling and we remain ready to assist you with various wealth planning services to ensure that you minimize taxes while maximizing your after-tax returns.

You work hard for your money – so we will too.

Ian Quigley, MBA

Qube Investment Management Inc.

Qube Investment Management Inc. is a registered portfolio management firm in the provinces of Alberta and British Columbia.

We offer Institutional and Private Wealth Management to those with $250,000 or more to invest.

We are proud to serve you from our offices headquartered in Edmonton!

Kaleo: to call, summon, or invite...
Our invitation to you, to invest with us

At December 31, 2015

	2015	2014	2013	3-Year	5-Year (Inception)
KALEO A	11.9%	20.7%	33.7%	21.8%	15.4%
KALEO B	16.1%	17.9%	33.4%	22.2%	15.1%
KALEO FULL	14.3%	22.0%	35.0%	23.4%	16.0%
S&P 500 (US Benchmark)	21.0%	24.0%	41.5%	28.5%	20.1%
S&P TSX (Canadian Benchmark)	-8.4%	10.9%	12.7%	4.6%	2.3%
50% TSX / 50% S&P 500 (KALEO BENCHMARK)	6.3%	17.5%	27.1%	16.6%	11.2%

Kaleo is Qube's stock model, which is offered as follows:

Kaleo Full – currently a 43 stock + 2 index ETF model offered to clients with $1M+ positions

For clients with positions between $250,000 to $1M, we offer two subsets of the Kaleo Full model:

Kaleo A – currently a 25 stock + 2 index ETF model

Kaleo B – currently a 23 stock + 2 index ETF model

Our model portfolios were launched in January of 2011. They continue to report a lower risk metric (beta) and generate a superior return when compared to our performance benchmark of 50% of the TSX (CAN) & 50% of the S&P 500 (US) indexes.

We currently aim to hold a stock for 3-5 years in our Kaleo models. This means we have an average portfolio turnover of 25%. In other words, a quarter of our positions change each year on average.

One goal with Kaleo is to generate income through dividends. An investor entering Kaleo at inception would have a dividend yield today of over 3.5%. Many of the companies in our portfolio increase their dividends each year, so an investor can therefore grow his or her dividend over time.

An investor entering Kaleo today would see a starting dividend yield of about 2.0%.

In the management of our Kaleo model, we use both company specific / fundamental analysis and macroeconomics to determine our positions (what to buy/sell).

Our research universe refreshes each year and we currently track between 150 and 200 companies. To learn more about our investment philosophy, please see our investing brochure at www.qubeconsulting.ca.

Kaleo at a Glance

Patrick Choi
Ian Quigley, MBA

Why We Poked the Bears Again: Auditor Rotation

Ian Quigley, MBA

It was seven AM and I was grumpy. Sleep was interrupted with jabs of anxiety and I was struggling to dial into the nine o'clock (EST) conference call. I hate conflict, and often go to great lengths to avoid it, but today that would not be possible. Scheduled in first thing was this politely acrimonious conference call, potentially being repeated 44 times this winter. I was starting to question my choice of career.

As a portfolio manager I represent investors. I am their fiduciary, and I want to see the world they invest within change for the better: corporations would better understand that they are accountable to shareholders and, in turn, shareholders would care about the corporations that they own. With the proliferation of mutual funds in recent decades, this key connection between shareholders and management has been lost. What shareholder ever considers attending an Annual General Meeting (AGM) anymore? Herein lies the potential source of very expensive troubles for investors…

At Qube, we believe that owning shares in a public company is no different than owning a rental house or condo. Property is property and ownership brings certain responsibilities. We should be as equally concerned with the board, executives and activities of the companies we own in our retirement portfolio as we would be with tenants in a rental property. Obviously, this is a very large task, especially if a number of companies are in your portfolio. You also have a job, a family, sports and hobbies, and the fact is that you have a life outside of your investment account. Enter here the role of your investment manager, who needs to sufficiently represent you and your ownership interests. The stocks you invest in are your store of wealth; they represent your ability to retire and to hand down a legacy.

The conference call starts as many do, with the VP of Investor Relations and the Senior Legal Counsel providing a 20-minute monologue about the auditor relationship with their multinational firm. I have already heard the speech a few times this winter and patiently wait for my turn to share. Why the lecture? Qube submitted a proposal on behalf of its investors asking that the audit committee hold a competition for the audit engagement no less than every 8 years. Our proposal does not please management or the board.

This particular public company has not formally considered an auditor change in 23 years, and they show some frustration at the concept. Frustrated that a shareholder has exercised the right to submit such a proposal. Frustrated that the proposal would be read and voted upon by

thousands of other shareholders, bringing attention to the issue. This is Qube's intent, and one that management would prefer to dispose of before the upcoming shareholder's meeting.

My turn comes to talk, and I begin to explain the importance of auditor rotation. Qube is not the first proponent of this topic; it has been debated by various US, Canadian and European regulators and policy makers in recent years. It takes no time at all for the frustrations to flare. The senior legal counsel exclaims that such a request of management and the board would be awkward. In fact, "it would be *simply awkward* to open a discussion on a change in auditor after so many years of positive audit results and healthy relationships."

My grumpiness instantly evaporated and I felt better about my life. Comments like this are as rare as the sage grouse in southern Alberta. I allowed a small pause for reflection, and then pointed out that such a comment was the exact reason the auditor needed to be rotated from time to time. It was an easy score and allowed the call to quickly come to a close. Thanks to Canadian regulatory procedure, Qube's shareholder proposal will pass through to the AGM without executive obstruction, a rare victory for us.

Governance is the Starting Point

As we discussed in our commentary last quarter, governance scandals are costly (our example being the drama at Volkswagen). Governance is key to the protection of shareholder value, and the annual audit is a key process intended to protect shareholder interests. Shareholders are asked to elect an auditor each year who will independently review and report on the results and activities of the corporation. It is the board that places the audit firm on the proxy for the vote, but

each time, year after year, decade after decade it is often the exact same auditor. American and Canadian companies have a terrible habit of simply rolling the audit engagement over; shareholders are then asked to rubber stamp this enduring commitment, which they usually do.

Common logic challenges this. History challenges this (Enron, American Banking Meltdown 2008, VW). However, shareholders largely do not challenge this. The United Brotherhoold of Carpenters in the US has. In 2014, they submitted questions to Fortune 500 companies with long-tenured auditors, looking to highlight the need to "protect the necessary independence, skepticism and objectivity auditors have toward their audit clients in light of the extremely long and lucrative tenures that characterize the relationships between for-profit audit firms and their corporate audit clients."

The Netherlands has recently challenged this. The new Dutch Audit Profession Act (2016) will impose a mandatory rotation of audit firms on listed companies once every 10 years. The EU also has upcoming regulations (June 2016) where the initial engagement period of a statuary auditor/audit firm cannot be less than one year and must not exceed 10 years (unless a tender is conducted or there is a joint audit arrangement). In India, Section 139(2) of the Companies Act has mandated that all listed companies must rotate their auditors after 10 or more consecutive years (April 2017). The UK's Financial Reporting Council began enforcing "comply or explain" governance rules around rotation, with the expectation that auditors go up for bid every 10 years.

Objections aside, results are positive when the audit rotates. Since October 2012, over two-thirds of 51 FTSE 350 companies who put auditing contracts out for bid ultimately exercise as useful, as "a fresh pair of eyes brought new things to light." In Italy, mandatory auditor rotation has been required since 1975 and the equity markets function just fine.

Technical Barriers

Sadly, we were quickly buried this year with incredible technical challenges. The right to submit a shareholder proposal, in most jurisdictions, requires only $2000 of shares held for 1 year. The bar is intended to be low, as active share ownership is healthy for the public markets. Active shareholders keep the executive culture accountable and boards sharp. Nonetheless, our proposals were responded to with a number of scathing technical objections including:

- The method used to count the words in our proposal; or
- Challenges to our proof of ownership; or
- Challenges to our custodial verification about proof of ownership; or
- That the proposal was operational and not governance related; or
- A portfolio manager is not eligible to represent investors in this manner; or
- The list continues to grow...

It is shameful that an investor needs to hire a legal specialist to prove $2000 of ownership has been held for 1 year, or to fight the often dizzying pushback that comes with a simple request for consideration. It is also a perfect example of how the system needs to change; shareholders need to repossess the assets they own and portfolio managers need to step up and expect more from our public markets.

Qube has proposed for most of the companies we invest in that shareholders consider a competitive bid process for the audit engagement no less than every 8 years.

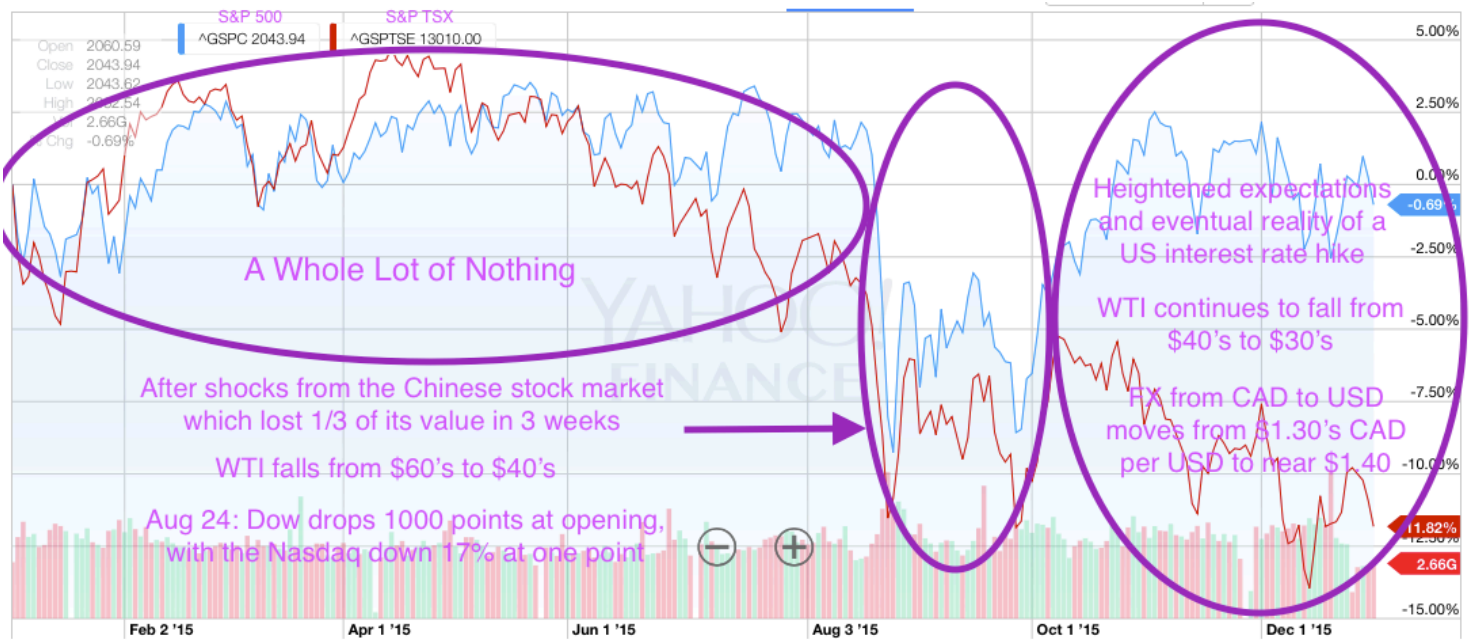
This is sourced from Dr. Robert Pozen and a Harvard Policy Forum in 2012.

Big Macro – Is the Stock Market Poking a Bear in 2016?

Patrick Choi
Ian Quigley, MBA

Investment returns for the past 2 years have followed a consistent pattern: each year is worse than the last.

We believe this trend will continue for 2016, but before we dig into the "whys", lets recap what happened back in 2015.



Despite this, (and on a currency adjusted basis) our Kaleo model showed solid performance in 2015. We are optimistic about 2016, but do see a number of headwinds that will mute our expectations. Are we poking enough "Bear Factors" to call a "Bear Market"? Read on.

US Earnings (Bear Factor). According to Reuters, U.S. corporate earnings in 2015 were flat. Qube expects 2016 to produce similar earnings as in 2015, as many of the themes continue. Due to the relative strength of the U.S. economy, and the much anticipated rate hike in 2015, the U.S. dollar has appreciated substantially relative to a basket of other major currencies. We believe the U.S. dollar will remain at elevated levels for 2016 as the investment community wholeheartedly anticipates further rate hikes. A strong U.S. dollar makes U.S. goods and services less competitive contributing to lower earnings from international sales. Especially when converted back into U.S. dollars for financial reporting.

Energy Prices (Bull Factor). Oil prices have dropped near 70% since $100 oil in 2014. We believe oil prices will stay "lower for longer", which translates into bad news for energy companies (who hold a significant portion of the stock market). It will also destabilize oil exporting counrties like the Saudis, Venezuala and Russia. That was the bad news. Cheap oil is also stimulative for the rest of the stock market and non-exporting countries. On balance, cheap oil is a Bull Factor for investing in 2016, despite the drama it may attract.

Continued Slowdown Internationally (Bear). U.S., Europe, and China are by far the most important areas in the world when speaking of corporate earnings. According to FactSet Economic Estimates, real (year-over-year) GDP growth in the U.S. is projected to be 2.6% in 2016, which would be consistent with GDP growth of the past few years but still below historical averages of about 3%. The same source estimates that Europe and China would have real GDP growth of 1.7% and 6.5% respectively, which are both well below historical norms. Slow or slowing growth puts a damper on revenues, which in turn could lead to lower earnings (especially outside the US).

Cost of Labor (Bear Cub). Since 2009-2010, unemployment rates in the U.S. have steadily fallen from a high of 10% to the around 5%. The closer unemployment trends towards full employment, the higher the cost of labor will become. Any uptick in the labor cost for 2016 will contribute to a squeeze in corporate profitability. While possible, we do not see this as probable in 2016.

Stock Prices (Bear Cub). Trailing twelve month Price-to-Earnings for the S&P 500 is currently sitting at around 20. Average Price-to-Earnings, if we go all the way back to the late 1800's, would be around 16. From these 2 facts, you could say that the S&P 500 is currently "expensive". We believe this is a hasty conclusion, as it does not take into account other investment alternatives. After factoring in the extremely low interest rates of U.S. treasuries (currently 2.1% for the 10 year). We feel it is more appropriate to classify the current stock market as "not cheap", rather than "expensive".

United States Presidential Election (Bull Factor). This election is scheduled for November 8, which means more time for election activity to contribute to market drama. While stocks historically perform well in a presidential election year, this year may see more volatility due to strong competition from outliers like Donald Trump and Bernie Sanders. Both candidates have now developed a cult-like following from the portion of the population who are fed up with the current political establishment, and who are in favor of radical policies to shake up the status quo. Regardless of which candidate you feel is best for the future of the USA, the markets tend to do well in election years and we are claiming this as a Bull factor!

Interest Rates (Bull Factor). In the middle of December 2015, the U.S. Federal Reserve hiked interest rates for the 1st time since 2006 with an expectation of more rate hikes to come. This means the Federal Reserve in poised to fight inflation and manage growth (not manage a slowdown). While this may seem unreasonably optimistic, it is a good sign. It is clearly a bull!

We believe it less likely that the Federal Reserve will hike rates much in 2016 as it would assume:

a) Healthy U.S. economic growth;
b) Continued improvements in the unemployment rate;
c) U.S. inflation moving towards the central tendency of 2%;
d) Stabilization in oil prices;
e) Economic stabilization of important regions of the world like Europe and China; and
f) A slowdown, if not a modest drop, in the strength of the U.S. currency relative to a basket of world currencies.

Geopolitical Stability (Bull Factor). Gosh its quiet out there! At the moment, the relative stability out there is a Bull Factor we can certainly count. Investors like stability and until Russia misbehaves again, or North Korea or Iran we can count our blessings and our invested dollars.

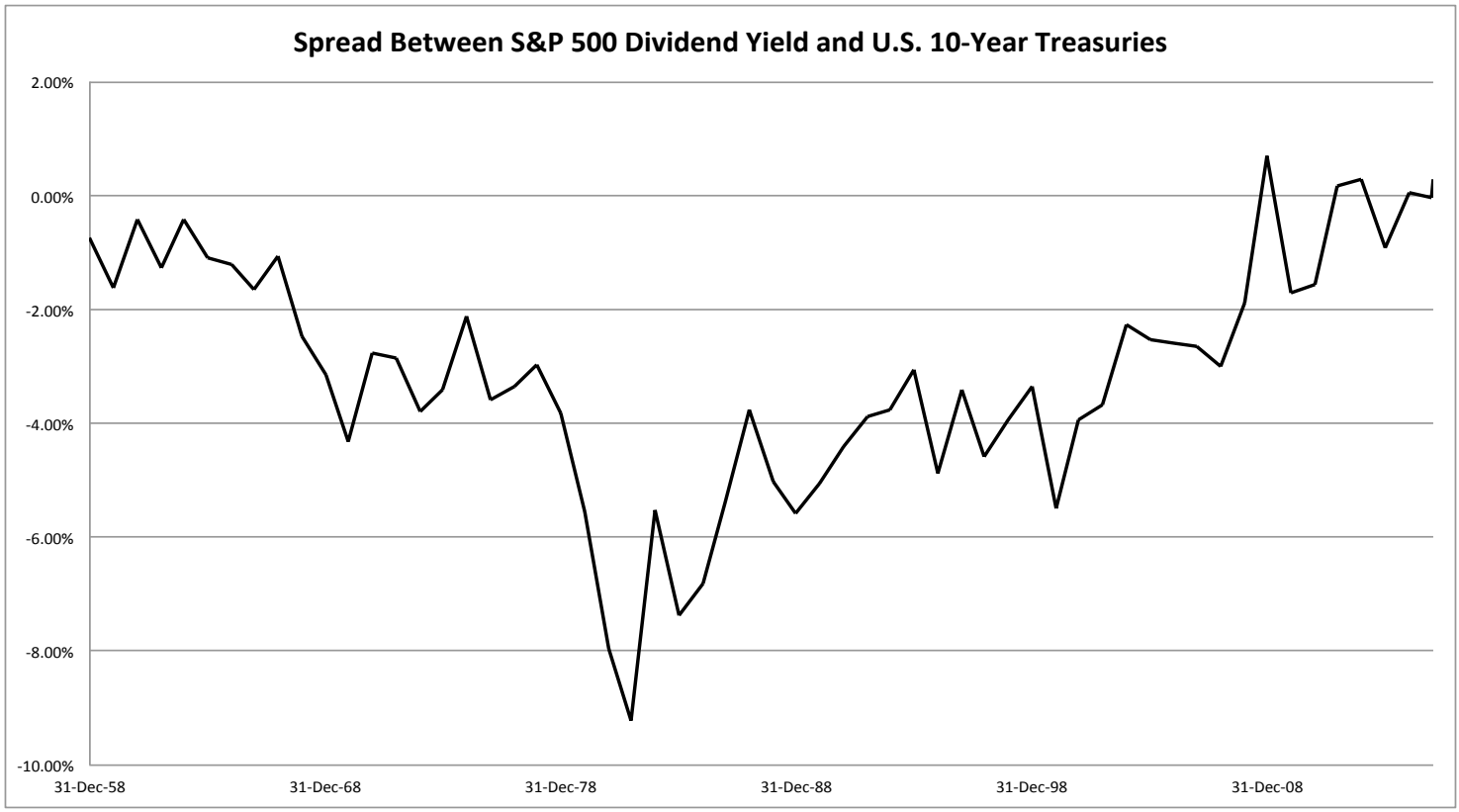
Are we Poking the Bears in 2016?

No. The most infuencial factors on 2016 are global GDP growth rates (expected to be just below historical levels in 2016), the stimulation of low energy prices, the absence of inflation and favourable interest and monetary policies. All are in place.

In fact, if we compare U.S. 10 year treasuries to the S&P 500, we can argue that U.S. bonds are actually more expensive than U.S. stocks.

The math is as follows. The current yield on the 10-year is 2.0%, while the yield on the S&P 500 is 2.3%. This means that, over a 10-year period, holding the S&P 500 would provide a higher return than holding treasuries, without accounting for capital appreciation. While we admit there is safety in treasuries, the odds are in our favor that stock prices, after a 10-year period, will be at higher levels than what they are trading at today. Accounting for positive capital appreciation should mean substantially higher returns for U.S. stocks than for U.S. bonds in the next 10 years.

If investors invest using a long-term horizon (as they should), this particular event should not be occurring. In fact, this type of "abnormal" spread has occurred just 5 times in over 50 years. Through these lenses, stocks don't look particularly expensive to us – despite the drop in the stock market over the first 2 weeks in January (see the graph indicating this relative valuation of stocks to bonds).



With all of this information, what then is our plan?
Our advice has always been to hold the course, unless we feel there is a high possibility for economic contagion in the near future.

We define economic contagion as a feedback loop where one economic event produces results in a second. Then, in turn, the second event influences the first.

An example would be the subprime mortgage crisis, which took down housing prices in the US and elsewhere in the world. This event led to a collective fear of decreased net worth, which led to decreased spending, which led to layoffs in the economy, which led to even less economic spending, and on in a feedback loop.

In our opinion, the only way to stop this loop, once it starts, is to take (willingly or unwillingly) drastic measures such as the bailout program of $29 trillion (U.S. GDP is only about $17 trillion by some estimates) during the subprime mortgage crisis.

Fortunately, we do not see contagion as a high possibility in 2016. Much of the volatility in recent months has been attributed to the sharp drop in oil prices and the slowing Chinese economy (after years of stellar growth).

While the Chinese economy has indeed slowed, it has not stopped and is still estimated by economists to grow at approximately 6.5%. In addition, unlike a decline in housing prices or technology stocks during the tech bubble, a decline in oil prices creates both winners and losers instead of just losers. In our opinion, these facts make this situation very different from 2008, or any other period in history with economic contagion.

What could cause contagion in 2016? Dramatic changes in U.S. unemployment rates, global and/or U.S. GDP growth and signs of deflation are good possibilities. As such, we actively monitor the macroenvironment accordingly.

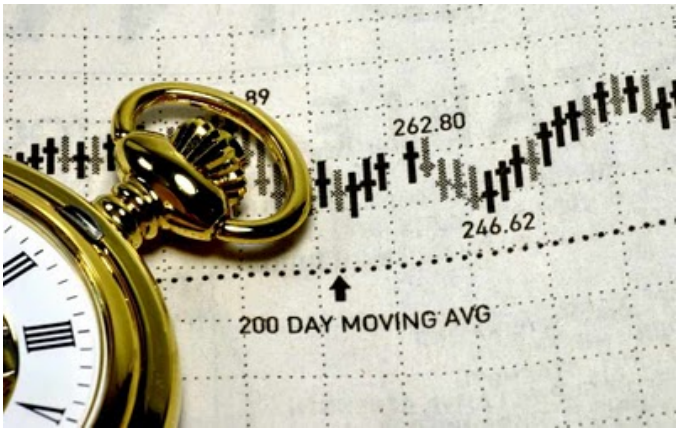
For now, we do not see current issues spreading beyond the lowering of growth expectations in China and companies that do business in China. Certainly economies that depend on exports of energy or commodities (e.g. Canada, Australia, Russia, and much of the third world) are worth avoiding.

Over the years, we have made a number of changes to your portfolio so that possible negative influences discussed above would have little impact on your equity allocation. Despite us being Canadian, and the TSX being heavily exposed to energy, our portfolios are actually very light on both Canadian and energy content. We have also favoured larger, blue-chip companies that have proven history of making money, employing people and contributing to the economy.

Combining these facts with your individual asset allocation (bond content), setup with a long-term perspective, it is clear that the most prudent advice we can give our clients is to, "stay the course!". While Bull market expectations are muted in 2016, we do not believe the bears have been poked enough to warrant fears or plans of a bear market.

Timing is Not Everything

Anya Tonkonogy, MA



"Timing is everything", or so the old expression goes. But does that apply to the Stock Market?

We are all familiar with the havoc that emotions can wreak in our daily lives. From road rage to uncontrollable laughter, we can often find ourselves at the mercy of biochemical processes that can surprise with their intensity.

Not the least of which is 'fear'.

In 1933, amidst the devastation that followed one of the worst market crashes in history, Franklin D. Roosevelt in his first inaugural address, solemnly proclaimed to the people, that "the only thing we have to fear is fear itself". He was not wrong.

Yes, fear has served humanity well. It is a vital response to perceived danger, and has facilitated our coping on the planet since the dawn of time. Fear has provided good solutions to ancient and recurring problems that faced our ancestors.

But the bad news is that fear, when mixed with greed, can be a combustive mix, that threatens to burn down a rock-solid investment plan. Emotions make investors vulnerable to the dangers lurking in the shadows of 'bear' markets, and may cost us dearly in the long-term.

Nobody likes to lose. Standing by and watching your hard earned returns melt off during a market slump can be torture, and often feels like the most counter-intuitive response. Inaction is perceived as weakness, as we all want to get ahead of the storm, to know when to buy and when to sell, and ultimately how to win.

The Molotov cocktail of fear and greed can often lead investors to the common misconception that 'timing' the market will result in more wins.

At its core, it's the desire to find a good way to be invested in stocks when they're going up and to be on the sidelines when they're going down. What could be more logical than that?

That desire is the first half of market timing. The second half is the belief that "a good way" to accomplish that desire actually exists. But there's no general agreement that there's any such system. Otherwise, most investors would use it.

The reality, is that only 1 in 100 investors are successful using timing. [1]

Mutual fund data has consistently shown that investors tend to buy investments after they have increased in value and sold them after they fell.

For the 20-year period to the end of 2008, the inflation-adjusted market return was near 5.3%. The average investor managed to turn $1 million into $800,000 when the buy and hold investor increased it to $2.7 million (well diversified) [2]

Several independent organizations (e.g., Timer Digest and Hulbert Financial Digest) tracked some market timers' performance for over thirty years. These organizations found that 'market timers' in many cases do no better than chance, or even worse. A recent study suggested that the best predictor of consistent outperformance was low expenses and low turnover, not pursuit of a value or contrarian strategy.[3]

No investment approach can eliminate the risk of loss. The primary goal of timing is to limit your losses. Even if you use a trend-following system, you are essentially guaranteed to lose money, because you won't get out until the market has gone down enough to trigger a signal.
Turbulent markets test investor grit. It is especially important to maintain reasonable expectations and to stick to the plan during a downturn.

Timing is NOT everything.

Proper asset allocation and diversification are still thee cornerstones of true winners. Timing the market is a defensive strategy that can often be a kneejerk response with potentially regrettable outcomes. There are other defensive strategies that are already built into your Kaleo investments with Qube, such as bonds, that will keep your down moments relatively manageable.

In the meantime, while we weather the storm of the recent market, we need to keep in mind that just like road rage and uncontrollable laughter, there is a cost to being ruled by our emotions when investing.

Cooler heads will prevail, and history tells us that those who have a plan and keep their eye on the long game - win.

1http://www.marketwatch.com/story/portfolio-killers-7-market-timing-myths-2013-10-16

2(Commodities | Issue 14 | Investment Newsletter | MASECO Private Wealth).

3 (Malkiel B.G. (2004) Can predictable patterns in market returns be exploited using real money? *Journal of Portfolio Management*, *31 (Special Issue)*, p.131-141.)

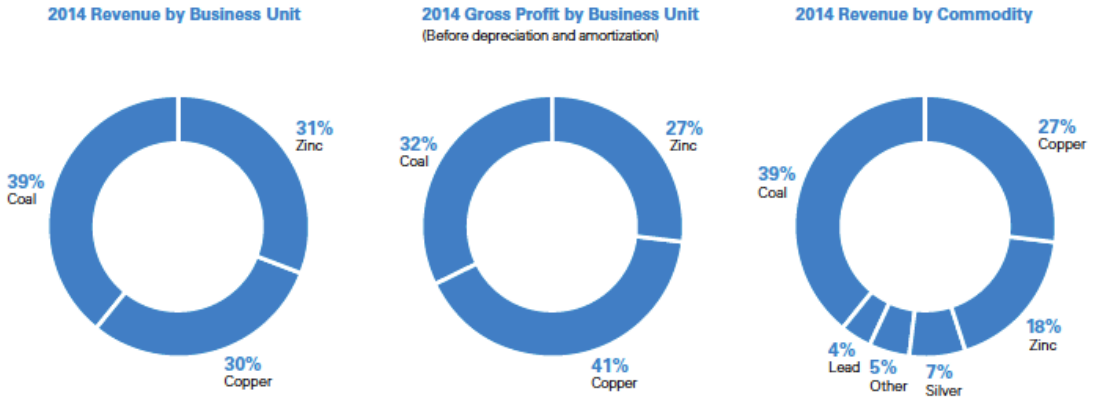
Trimming the Portfolio

Teck

Patrick Choi

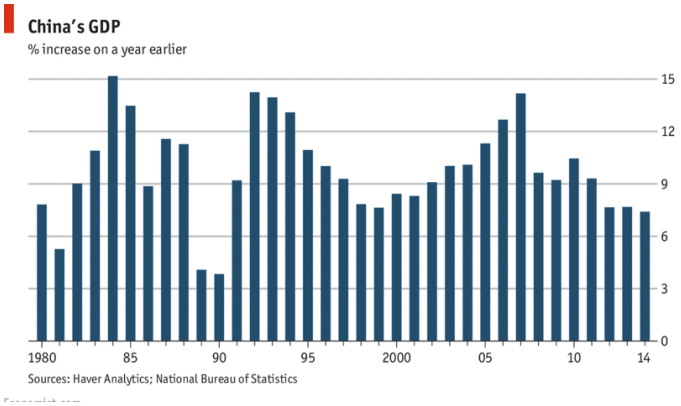
Teck Resources is a metals and mining company and is Canada's largest diversified resources company. Their focus is on coal (specifically coke coal, which is used to make steel), copper and zinc.

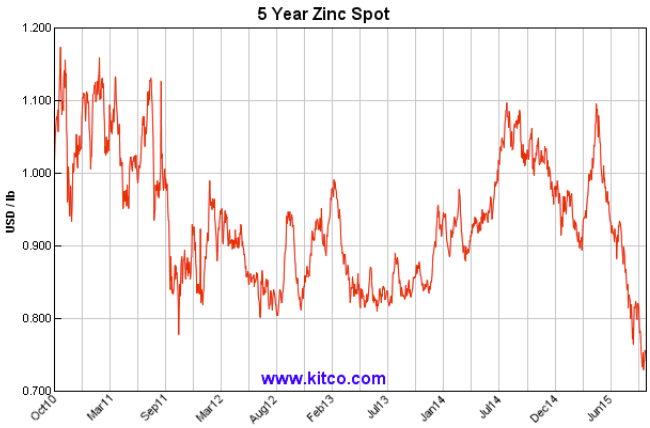
Zinc is currently the 4th most widely consumed metal in the world after iron, aluminum and copper. Half of the world wide production of zinc is used in zinc galvanizing which is the process of adding thin layers of zinc to iron or steel to prevent rusting. Next on the list is as an alloy where it is commonly combined with copper to form brass, or it can also be combined with other metals to form materials used in automobiles, electrical components and household fixtures. Lastly, zinc is used in the production of zinc oxide, which is then used in rubber manufacturing and skin ointment.



All in all, Teck resources mines materials that are highly leveraged to the economy (construction and manufacturing). Simplisticially speaking, if the economy picks up, Teck Resources should do very well. If the economy slows down, investors would probably do very poorly. Due to this reason, it is our belief that the analysis of Teck Resources as an investment should hinge on whether or not one believes there will be increasing or decreasing industrial demand in the world.

In hindsight, we now realize that one of the fallout effects from the subprime mortgage crisis was (and is) low GDP growth across the board, and low demand for goods due to a possible shift in consumer spending patterns as evidenced by low inflation. From the charts below, we can see the magnitude of the effect this has had on the products mined by Teck Resources.





It is our belief that there will be continued low global industrial demand, resulting from lower than normal GDP growth in 2016 across the globe including in major economies like US, China, Japan, and much of the developed economies. Much of this is as a result of the fallout from the subprime mortgage crisis where we are, right this moment, seeing low GDP growth across the board, and low demand for goods due to a possible shift in consumer spending patterns as evidenced by low inflation. Our reasons for the above are as follows:

1) **China's ghost cities, China's debt and China's rebalancing**. Much of the iron ore being consumed in China was used to build the infamous ghost cities. China did this in order to help spread out the population density of places like Shanghai, Shenzhen, and Beijing, among others as well as to help urbanize the still very rural population (approximately 622M people, or about half of China's total population, still live in rural areas according to The World Bank). At the end of the construction spree (cities are still being built, just on a much lower number and scale than previous), China was (and still is) left with hundreds of ghost cities complete with shopping malls and soccer stadiums.

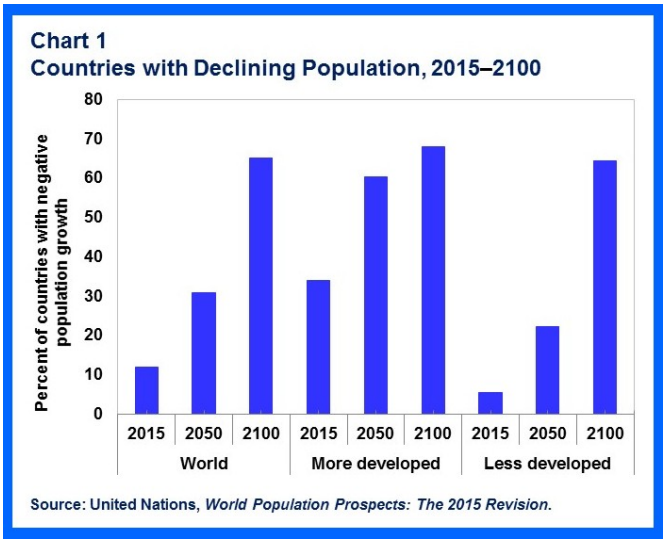
Besides the direct impact of less construction due to an oversupply of infrastructure, there is also the indirect impact from the debt funding used for the construction and other Chinese endeavours. China currently has a pile of public and private debt valued at approximately $28 trillion according to McKinsey & Co., which came about by quadrupling its borrowing over a 7 year period. This represented a massive buildup in debt and corresponded with the large infrastructure projects happening at the time. In terms of debt-to-GDP, China is currently at 282%, which is higher than the debt ratios of other countries like the U.S., Canada and Germany.

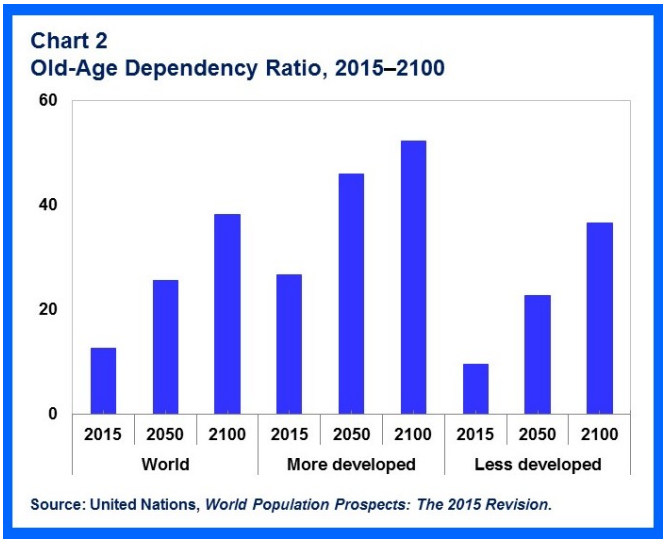
Even if we assume that China had the will to continue with the manufacturing and construction, it is our belief that they lack the means to do so, due to the ballooning of debt and the subsequent defaults already taking place. In actual fact, China does not have the will to continue with the manufacturing and construction. The Chinese government has already stated their intention to move towards a more sustainable economic model, where GDP would be more influenced by services and domestic consumer spending, and less influenced by industry and investment led growth. This rebalancing of priorities in China does not bode well for suppliers of those commodities, like Teck Resources, which is dependent upon industry and manufacturing.

With China's GDP slowing down (and predicted by the IMF to continue slowing down through the end of 2016), and combined with China's excess capacity relative to demand, it is our belief that there will be a greater focus in China on paying down debt going forward Vs. building things (construction or otherwise). A slowdown in the rate of spending on manufacturing and construction in China should correspond to large, incremental demand loss for all of Teck's products.

2) **Rise in US Interest Rates**. The raising of rates by the Federal Reserve has ramifications that extend beyond America's borders. December's rate hike and the stronger U.S. Dollar has already contributed to higher financing costs for those global borrowers whose securities are denominated in USD. We believe that a higher cost of global financing would contribute to less spending and consumption going forward on a global basis.

3) **Demographics**. It should be no surprise, in light of declining fertility and improvements in health care, that populations are both declining and getting older around the world. According to the United Nations, over 20% of the population in developed countries are older than the age of 65, and by 2050, this number will increase to over 40%. In addition, it is estimated that approximately 60% of the developed countries will have declining populations by 2050. For the less developed countries, we see similar trends on both counts, albeit to a lesser degree.





What this means going forward is that as the population ages and dies, we should see less overall spending growth on the simple basis of less people to demand goods, and the shifting of priorities from commodity intensive purchases like physical goods, to less commodity intensive purchases like services such as health care. Even if we ignore the economic challenges of such a demographic shift, the shift itself should already translate into less demand for all of the products mined by Teck Resources.

The fact is that much of the drop in commodity prices has been attributed not to the fall in demand, but rather to a rise in supply. A likely scenario would be that as demand rises, additional supply will come back online, which in turn will keep prices flat. At the snail's pace that global growth has been growing, and is forecasted to grow in the future, we suspect that it would take a substantial amount of time for the supply to work itself off, such that commodity prices can start moving towards sustainably higher prices. At the most foundational level, this disconnect between high supply and low demand is why we believe commodity producers like Teck Resources could be poor investments for the foreseeable future.

QUBE INSIGHTS: Kaleo Holdings

Patrick Choi
Ian Quigley, MBA

Kaleo Full, A

Canadian National Railway Company: CN is the largest railway company in Canada in terms of both revenue and track size. Today, CN's rail network spans from the Atlantic coast in Nova Scotia to the Pacific coast in British Columbia, making them Canada's only transcontinental railway company. In addition, CN also owns extensive trackage in the central United States along the Mississippi River valley, from the Great Lakes to the Gulf of Mexico.

Our underlying reasons for the purchase and continued hold on CN are as follows:

1) According to the Association of American Railroads, trains, on average, are four times more fuel-efficient than trucks. With global warming becoming a more present problem every year, and increasing demand on companies to cut costs, we believe there will be continued and increasing demand for goods in North America to be transported through rail.
2) Both Canada and the United States have high levels of government debt. Sometime down the road, these debts will eventually have to be paid through higher taxes and/or lower spending. One of the core differences between roads and railroads is that the infrastructure for trains are financed privately, while the infrastructure for trucks (roadways, bridges, etc.) is financed by the government. Moving forward, we believe there is a greater capacity for the railroad companies to spend on the necessary capital expenditure, than there is for the government to maintain and grow the necessary infrastructure the trucking industry relies upon.
3) We believe in the long term growth of the economy in both Canada and in the United States. 10 years down the road, it is likely that the GDP for both countries will be higher than where it is at today. This should, in theory, translate into higher number of goods being transported throughout both countries, with rail taking a sizable share.

"It's a business that has real economic advantages. If you look at fuel costs, drivers' wages on the highway – as long as more goods move from place to place in this country, rails are going to get their share, and it should be a very profitable business." – Warren Buffett on his purchase of Burlington Northern Santa Fe

QUBE INSIGHTS: Kaleo Holdings

Patrick Choi
Ian Quigley, MBA

PEPSICO

Kaleo Full, A

PepsiCo Inc.: PepsiCo is an American multinational food, snack and beverage corporation. They are responsible for the manufacturing, marketing, and distribution of their products, which include 22 iconic, billion-dollar brands sold across 200 countries around the world. A sample of the billion-dollar brands owned by PepsiCo include: Pepsi, Mountain Dew, Lay's, Gatorade, Quaker, Doritos and Aquafina. Based on net revenue, PepsiCo is the second largest food and beverage business in the world, next to Switzerland's Nestle.

We believe the following positive catalysts can help drive future growth for Pepsi:

1) When compared to The Coca-Cola Company, PepsiCo has an enviable product mix that can take advantage of the secular trend towards being more healthy and fit. Their brands in the category they call "Good-For-You", which includes Quaker Oats, Gatorade and Tropicana, accounts for approximately 20% of PepsiCo's net revenue.
2) Perhaps at its most fundamental level, PepsiCo can be broadly classified as a global distribution business that can move any beverage or snack food to any place on the planet, more efficiently and more effectively (prime shelf space) than almost anyone else. Individual product lines can wax and wane, but it is PepsiCo's distribution assets and relationships that can make the company worth holding forever.

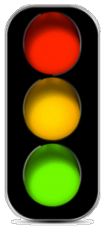
In summary, PepsiCo is one of the largest consumer staple companies in the world with revenues of $67B spread across multiple products, brand names and countries. They have scale, branding and can command pricing power on their products which have inelastic demand. These factors all contributed to consistent operational performance, which resulted in 43 consecutive years of dividend growth for PepsiCo shareholders. It is in these volatile times that we can most appreciate the consistent and stable operational results of a company like PepsiCo. What's there not to like?

"Pepsi sponsored the Super Bowl halftime show for a third straight year in 2015 and got a big bang for its buck with 118.5 million people tuning in. It was a bigger audience than the game itself." – Forbes, on Pepsi being #29 for the World's Most Valuable Brands

QUBE INSIGHTS: Equity Research Snapshots

Patrick Choi
Ian Quigley, MBA
German Michael III Martinez
Chris Pu

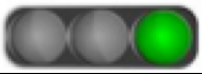
Our equity research is guided by a proven value-based approach pioneered by Benjamin Graham. Balancing traditional research techniques with modern portfolio science allows our team to find companies that demonstrate and maintain solid investing fundamentals. We look for less volatile and proven earnings combined with long-standing stable dividend policies. Share prices need to be justified on a combination of current earnings and reasonable earnings growth possibilities. Quality financial statements, coherent management and an operational business plan need to be in place before we rank a company "green".



Do not hold

Considering a decision to hold

Hold

	INDUSTRY	Current Status
3M	Industrials	
Bombardier	Industrials	
Canadian National Railway	Industrials	
Canadian Pacific	Industrials	
Corning	Industrials	
Cummins	Industrials	
Deere & Co.	Industrials	
Eaton Corp.	Industrials	
Emerson Electric	Industrials	
Expeditors Int'l	Industrials	
Fastenal Co.	Industrials	
General Electric	Industrials	
Iron Mountain Inc.	Industrials	

QUBE INSIGHTS: Equity Research Snapshots

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	INDUSTRY	Current Status
Leggett & Platt	Industrials	
Masco Corp.	Industrials	
Norfolk Southern Corp.	Industrials	
Pitney-Bowes	Industrials	
Quanta Services Inc.	Industrials	
Robert Half Int'l	Industrials	
Rockwell Automation	Industrials	
Rockwell Collins	Industrials	
Tyco Int'l	Industrials	
United Continental Holdings	Industrials	
United Parcel Service	Industrials	
United Technologies	Industrials	
W.W. Grainger	Industrials	
Xylem	Industrials	
Ball Corp.	Materials	
Dow Chemical	Materials	
DuPont	Materials	
Ecolab Inc.	Materials	
Int'l Flavors & Fragrances	Materials	

QUBE INSIGHTS: Equity Research Snapshots

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	INDUSTRY	Current Status
LyondellBasell	Materials	
Methanex Corp.	Materials	
Praxair	Materials	
Sigma-Aldrich Corp.	Materials	
AT&T Inc.	Telecommunications	
BCE Inc.	Telecommunications	
CenturyLink Inc.	Telecommunications	
Frontier Communications	Telecommunications	
Manitoba Telecom Services	Telecommunications	
Rogers Communications	Telecommunications	
Telus	Telecommunications	
Time Warner Cable	Telecommunications	
Verizon Communications	Telecommunications	

QUBE

DISCLAIMER: This is an internal report intended only for clients of Qube Investment Management Inc. The ideas presented within it form part of an overall portfolio management

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Commissions, management fees and expenses may be associated with investment accounts. Please read the simplified prospectus (if applicable), or investment management agreement before investing. Many investments are not guaranteed and are not covered by the Canada Deposit Insurance Corporation or by any other government issuer. There can be no assurances that an investment will be able to maintain its net asset value or that the full amount of the investment will be returned to you. Values change frequently and past performance may not be repeated.

Qube Investment Management Inc. is a registered portfolio management firm in the Provinces of Alberta and British Columbia and was registered as a portfolio management firm on June 25, 2012. Any return period cited before this date was prior to QIM being registered as a portfolio management firm. Inception was Jan 1, 2011 and all returns are for a modeled portfolio initiated at $500,000. Your actual returns may vary according to your individual portfolio. The modeled returns are calculated inclusive of dividends, adjusted to the Canadian currency, and are determined via the IRR (Internal Rate of Return) method. The gain/loss shown are simple (non-compounded) returns for periods up to one year. If the time since inception date is more than one year, then the return shown is an annualized return. For comparison purposes, the Kaleo model(s) are reported as gross returns before investment management fees. Individual investor level returns will differ as the fees agreed to in your Investment Management Agreement (IMA) are subtracted from the gross return.

At any one point in time, the composition of the Kaleo model may change. Currently, the focus for our models (Kaleo A, B and Full) is to invest in a globally diversified portfolio of liquid stocks with a minimum market capitalization of $1 billion. Our diversification strategy is to have similar industry weightings between our Kaleo models A, B and Full, which in turn will have similar weightings to the S&P 500. Our investment mandate is to not have any one industry sector or sub-group exceed 2.0 times the percentage weighting assigned to that group by the S&P 500 index unless the sector or sub-group composes less than 5% of the total index. Please refer to your Investment Policy Statement (IPS) for more details.

Index comparisons are based on the total return index provided by Standard & Poor's for both the S&P/TSX and the S&P 500. All index returns are inclusive of dividends, adjusted to the Canadian currency, and, similar to the modeled portfolio, determined via the IRR method. Please note that, as total return indices are not actual portfolios, these returns do not include the cost of management and/or trading fees.

Past performance is not indicative of future results and there is no assurance that our model portfolio will achieve its objectives or avoid significant losses

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