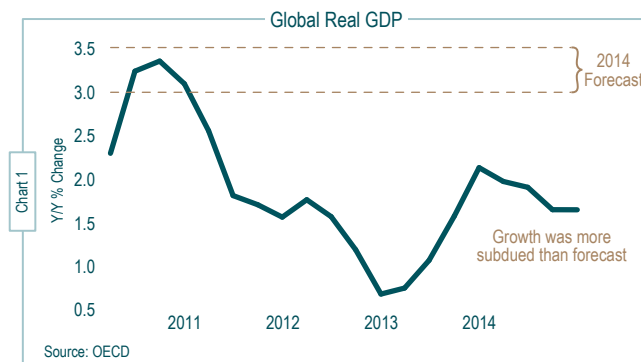


## THE YEAR IN REVIEW

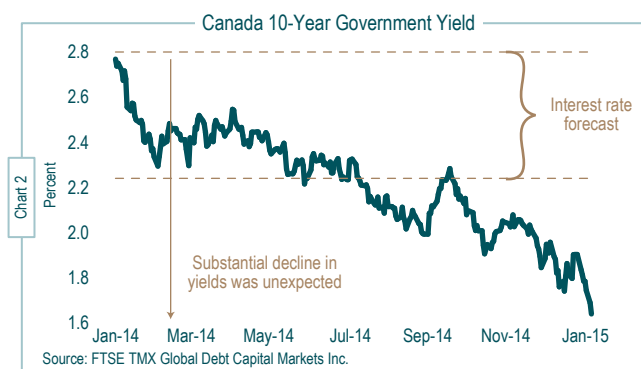
It is our custom at the start of each new year to review our prior year's *Financial Markets Forecast* and the results of our investment strategy, while keeping in mind that our forecast reflected a point-in-time view (January 2014) that evolved as events unfolded throughout the year.

Our global "base case" forecast called for persistent, albeit lacklustre growth for 2014, with global growth accelerating modestly for the first time in three years (3.0% to 3.5%). We felt that although the improvement in growth looked to be somewhat synchronized on a global basis, this masked both the differences in the relative pace and the asymmetry of the challenges faced across different regions. This proved to be the case as the US was well advanced in repairing its balance sheet while Europe continued to stumble along with an approach best described as "forbearance". Emerging markets were expected to improve, but collectively they faced serious challenges, particularly when it came to current account deficits and poor debt metrics. That said, a favourable global inflation backdrop would allow most emerging market countries to start to rebalance their economies while avoiding a hard landing.

We anticipated that the US would lead the global recovery because of improving business and consumer confidence, the release of significant private sector pent-up demand and relief from government fiscal drag. Supporting this scenario was an environment of benign inflation and very accommodative monetary policy. The biggest risk to our forecast would come from developments in Europe in the form of inaction by politicians at tackling structural reform and foot-dragging on the part of the European Central Bank (ECB), which could lead to a deflationary bust. With that in mind we put a 70% probability of our "base case" scenario unfolding which forecast that US real GDP would expand by 2.75%, Canada by 2.25%, Europe by 0.5% and China by 6.5%. Inflation was forecast to drop further due to weak commodity prices and monetary policy was to remain accommodative. The US Federal Reserve would keep administered rates unchanged, as would central banks in Canada and China, while the ECB was expected to lower rates. Our calls for lower inflation and little change, if any, in administered rates proved to be correct. Our GDP forecasts were correct in terms of direction, but actual results came up a bit short in terms of magnitude as 2014 GDP growth rates will certainly come in slightly weaker than what we had forecast (see Chart 1).

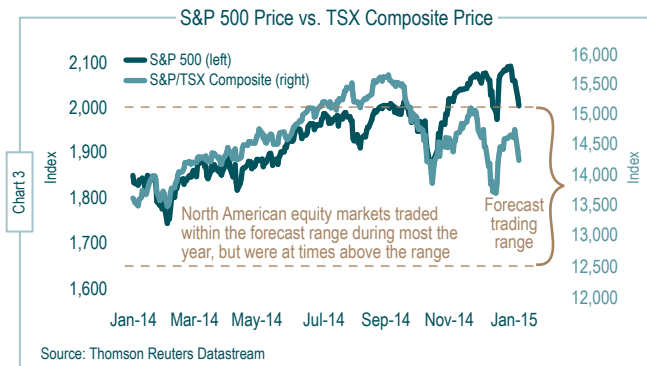


In summary, our financial markets thesis called for persistent, albeit lacklustre global economic growth, accommodative global monetary policies, receding inflation in all regions and favourable technical conditions, while acknowledging that valuation metrics for both stocks and bonds were stretched. This made us somewhat cautious when it came to fixed income markets, which led us to call for the 10-year government of Canada bond yield to trade in a range of 2.25% to 3.0% with a bias to the upside. This was expected to produce a total return of only 2.75% as measured by the FTSE TMX Canada Universe Bond Index (Universe Index). Actual results were much better as the Universe Index posted an 8.8% return (see Chart 2). Lower North American interest rates are due in part to the knock-on effect of the collapse in yields in Europe where deflationary forces continued to stalk the continent. Also, a change in the supply/demand equation came into play as issuance fell while demand increased as central banks, sovereign wealth funds and pension plans increased their bond buying programs.

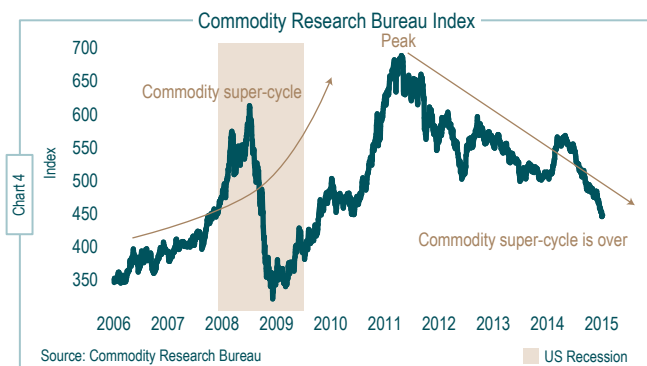


While stock valuations were also registering a bit on the high side, there were enough mitigating factors at play to push prices higher. From a regional perspective, we were fairly bullish with

the expectation that developed equity markets would outperform emerging markets. This was the case in the US with the S&P 500 Index gaining 11.4% and other developed markets rising substantially, with the MSCI EAFE countries up 7.7% in aggregate while the MSCI Emerging Markets Index only returned 2.5% (all in local currency terms). More specifically, we felt that the S&P/TSX Composite Index would trade in a fairly wide range from 12,500 to 15,000, while the S&P 500 Index would trade between 1,650 and 2,000, and both indices would end the year producing an 8% to 9% total return. North American markets performed slightly better than forecast with the S&P/TSX Composite Index also posting a double-digit return (see Chart 3).



Our bullish stance on the outlook for stocks was based on the assumption that earnings growth would be in the high single-digit range and profit margins would remain elevated due to low capacity utilization rates and increased capital spending. We acknowledged that stocks were a bit on the expensive side with price-earnings ratios (P/E)s through historical averages. To us, this meant that there was little or no room for multiples to expand or to act as a cushion for the stock market should earnings growth disappoint. As such, growth in earnings would become the prime driver of stock prices in 2014, whereas multiple expansion was the key driver in 2013. Companies with superior growth characteristics were forecast to outperform lesser-quality companies and cyclical stocks carried the most risk given the commodity super-cycle was over (see Chart 4) and US shale oil was a game changer. We focused on companies that would benefit from a US economic recovery with a particular emphasis on industrial and technology stocks. This strategy was rewarded as most of our Canadian portfolios outperformed their



respective benchmarks. Also, equity markets were largely earnings-driven, as forecast, which provided the opportunity to add value.

Within fixed income portfolios we were quite constructive towards credit because many of the factors that made us bullish on stocks also applied to the credit markets where the pick-up in yield exceeded 1% over Government of Canada bonds. We felt that positions concentrated in higher-quality corporate and provincial issuers would outperform with provincial credits being the most attractive. This turned out to be the case, which helped most of our fixed income portfolios to outperform their respective benchmarks. When it came to yield curve strategies, we thought that the front-end of the yield curve would remain anchored, which meant that some of the best performing areas would be in the longer-dated maturities, such as 5- to 10-year bonds. This also proved to be the case, which added to overall total returns in bond portfolios and helped to overcome the shortfall in performance from our short duration strategy.

It was our contention that as we entered 2014, financial markets would be driven more by country-, sector- and stock-specific events rather than global macro factors such as the risk-on versus risk-off attitudes that prevailed over the past few years. As such, we thought relative value would be an important theme and managing idiosyncratic (specific) risk would lead to success in setting asset mix and picking stocks and credit. This proved to be the case.

From an asset mix perspective, three of our five stock/bond valuation models were predicting an advantage for stocks over bonds, which was consistent with expected outcomes from our “base case” scenario. We took this as a signal that balanced portfolios should be overweight stocks versus bonds. Basically, we thought that the bottom line was stocks should be favoured over bonds because of their appeal on a relative valuation basis, accelerating global economic growth, low inflation, supportive monetary policies, rising corporate profits and a lacklustre outlook for fixed income markets. While the return from fixed income markets was anything but lacklustre, our forecast calling for an overweight position in equities versus bonds, because of various other factors, proved to be correct, with the MSCI All World Index (net) up 13.5% (in C\$) versus the 8.8% gain in the FTSE TMX Canada Universe Bond Index. While our forecast was correct, our tactical execution resulted in practically no added value.

Finally, we noted in our *2014 Financial Markets Forecast* that the coming year would have its share of surprises and we stood prepared to adjust our thinking and portfolio positioning as circumstances changed. While we fine-tuned our portfolio positioning from time to time as conditions warranted, on balance we remained committed to our “base case” scenario which, by and large, played out – just not as precisely as forecast.

**Wishing Everyone a Happy and Prosperous New Year!**