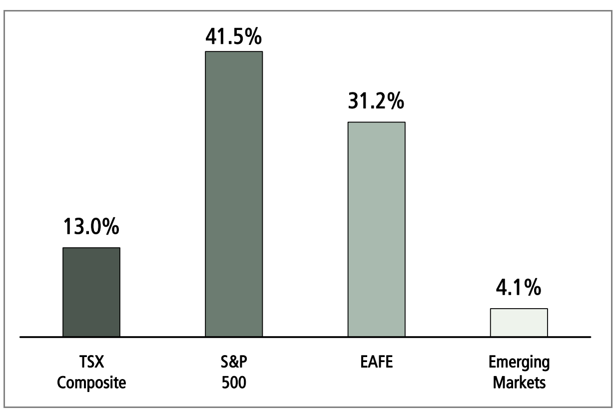
Happy Days are Here Again

It is a rare investor that does not look back at 2013 with a big smile on his or her face. The year started with a relief rally as U.S. lawmakers reached an 11th hour agreement in the wee hours of January 1st to avert a plunge off the "fiscal cliff". From there, the market never looked back and made strong gains through the year. Indeed, the S&P 500's total return of 32.4%[1] is its 13th best year in history. The NASDAQ and small cap stocks were even better.

By comparison, the TSX total return of 13.0%[2] seems disappointing. Many sectors of the Canadian market generated excellent returns, but the index was weighed down by a 29.1% decline in the Materials sector (mostly mining stocks). While Canadian investors might not have enjoyed the same exhilarating ride as those in the U.S., most should have realized very satisfactory returns over the year.

In developed markets outside of North America returns were almost as strong as in the U.S. For example, EAFE[3], the index of stocks in all non-North American developed markets, rose 31.2% last year, despite the ongoing struggles of many European economies. The only real disappointment was Emerging Markets, which provided a return of only 4.1%. Emerging Markets faced several headwinds, not the least of which was the preference of many investors for less risky (and booming!) developed markets.



Total Returns (C$) for Year Ended December 31, 2013

The incredible strength of U.S. stock markets surprised most observers given the numerous hurdles the U.S. economy had to clear over the course of the year. If one looks back at the four previous editions of *The Nexus Report* (which we know most clients do regularly!), one is reminded of one crisis after another. A year ago, it was only a last minute deal among lawmakers that averted the potentially catastrophic "fiscal cliff". In the first quarter, "sequestration" was the focus as the U.S. Government implemented across-the-board spending cuts that most believed would significantly reduce economic growth. In July, we wrote about the "taper tantrum" that sent global markets reeling in late June. Of course, this refers to the U.S. Federal Reserve musing about the ultimate need to taper (i.e., reduce) stimulus by purchasing somewhat less than $85 billion of U.S. Treasuries per month.[4] Investors reacted as if this were taking a patient off life support. Finally, our last report discussed the impact of the U.S. Government shutdown, and the possibility that the U.S. Treasury might actually default on some of its debt obligations.

Despite these challenges, however, the U.S. market had one of its best years ever. Investors clearly saw these moments of high drama as noise rather than news and focused on the more fundamental improvements in the U.S. economy that unfolded.

Too Far, Too Fast?

The obvious concern for investors is whether the momentum of 2013 can continue into 2014. The U.S. stock market and many others have run a long way. Some believe we are overdue for a correction.

To be sure, there are many reasons for caution going forward. In 2013 equity mutual funds had their biggest annual inflow since 2004. The ratio of cash in money market funds to total stock market value has fallen to 12.9% from 46.9% in 2009.[5] Clearly, retail investors are piling into the market to chase returns, which is rarely a good sign. On the valuation front, the Cyclically Adjusted Price Earnings multiple[6] devised by Yale professor, Robert Shiller, is flashing a warning that current market levels are unsustainable. Lastly, it is important to remember that none of the financial challenges facing the U.S. government has actually been solved. The U.S. spends more than it can afford, owes more than it seems able to repay, and Democrats and Republicans still cannot agree on

1 This return is expressed in US$. Because of the weakening C$ it was even more dramatic in C$ terms, gaining 41.5%.
2 This, and all subsequent returns quoted, are total returns in C$.
3 EAFE stands for Europe, Australasia, and the Far East.

4 The Fed did start to taper in December and now is buying only $75 billion per month!
5 From Ned Davis Research quoted in *Barron's* January 4, 2014.
6 Simplistically, CAPE is the current market price divided by the average of the last 10 years' earnings.

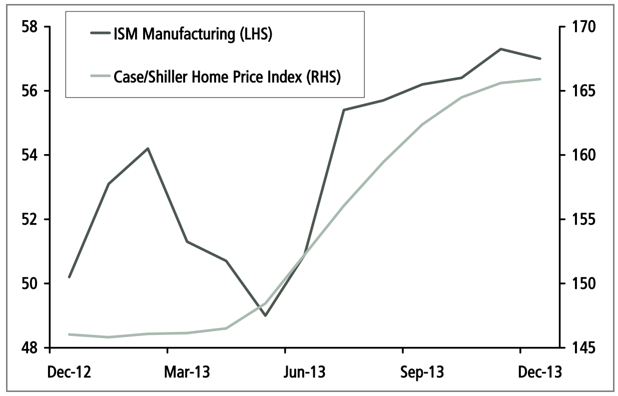
whether it is day or night. In short, the risk of disruption remains.

Momentum May Continue

Despite these issues, we retain a positive outlook for the year ahead. In the U.S., the long slow recovery from the Great Recession in 2008/2009 is gaining traction and even accelerating. Europe appears to be emerging from its lengthy recession, and Japan's attack on deflation seems to be winning – at least for now. In Canada, growth is subdued, but we believe it will remain positive. 2014 could be the first year in many when investors enjoy a period of synchronized global growth.

Despite stock market gains in the U.S. in the last couple of years, economic and corporate profit growth has been lacklustre. In our view, several positive trends could lead to a significant improvement in the real economy in 2014. As an example, the Case/Shiller Home Price Index has increased at a double digit year-over-year rate for several months in a row, improving many Americans' financial position and promoting greater confidence among consumers. Business confidence is also improving, as reflected in the monthly survey of purchasing managers (ISM). Of course, the most critical measure of all is employment, and labour market measures are giving mixed, but generally positive signals. Despite the disappointing non-farm payroll report for December (74,000 new jobs compared to an expectation of 197,000), the U.S. has been adding jobs at the rate of almost 200,000 per month for the past year. Virtually all of the 8.5 million jobs lost in the Great Recession have now been recouped. From a peak of 10% in the fall of 2009, the U.S. unemployment rate has fallen to 6.7% in December. The only caveat to this good news is that part of the decline in the unemployment rate is attributable to a decline in the participation rate – people dropping out of the workforce – not solely the expansion of payrolls.

Given the prospect of improved economic growth in the U.S., we think investors may be underestimating the potential for a surge in corporate earnings. Both revenues and margins of U.S. companies are levered to increases in GDP growth. Even a small uptick to economic growth could lead to a large upside surprise in earnings, especially earnings for cyclical companies. While Shiller's CAPE valuation metric may be rich, most traditional measures suggest the market is trading only at long-term average valuation levels. Accordingly, stocks could have a lot more upside should this earnings growth be realized.



Improving U.S. Economic Indicators

The Canadian economy remains very much as we described in recent quarters. Growth should stay positive, but less robust than that in the U.S. Consumer indebtedness is high and weighs on consumer spending. Our labour market also has weakened, as underscored by the loss of 46,000 jobs in December. Through 2013 the Canadian economy generated an average of 8,500 new jobs per month, a third of the pace we enjoyed in 2012. On the positive side, the recent decline in the Canadian dollar will help our export industries, which have struggled in recent years. The Canadian dollar's strength over the last several years has been driven by foreign demand for Canadian condos and government bonds, rather than a desire to invest in ketchup or auto plants. The Canadian industrial sector has stagnated as a result. Nevertheless, the single most important factor for the health of the Canadian economy is the strength of demand from the U.S. Should economic growth in the U.S. improve as we imagine, this will ensure at least modest growth in Canada.

As we have written frequently in the past, it is impossible to reliably forecast market movements in the short term. We're hopeful that this positive market cycle we are now enjoying will persist for a while longer, but we are mindful that there remain many risks that could derail it. The only forecast that we have great confidence in is our forecast for the long term. We believe that our client portfolios hold a diversified collection of excellent businesses that are valued sensibly. Over the long term, we are highly confident that these investments will reward clients handsomely.

Asset Class Investment Review

Fixed Income

2013 was one of the least rewarding years for bond investors in many years. This year the DEX Universe Bond Index (DEX) produced a negative return of 1.2%, the first annual loss since 1999, when the DEX produced a negative return of 1.1%. Thankfully, our returns were better than the DEX.

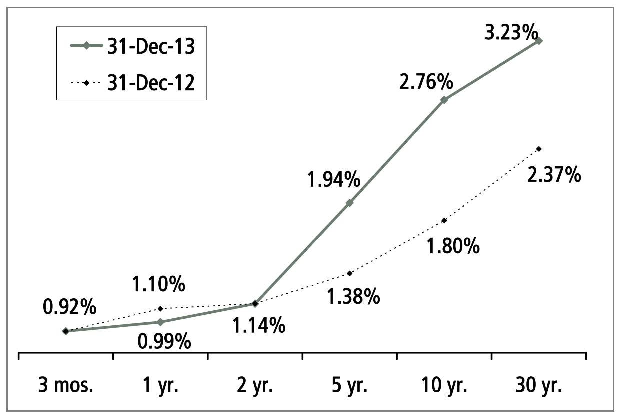
The disappointing returns are a consequence of the market's concern about a looming tightening of monetary policy by central banks, if and when the economy shows signs of sustainable recovery. Over the course of this past year, the economic recovery, particularly in North America, has shown signs of needing less monetary stimulus than it had previously. As illustrated in the attached graph, interest rates for short maturity bonds were virtually unchanged in 2013, while interest rates for longer maturities rose significantly.

Losses in the bond market typically arise when central banks are withdrawing liquidity and actively tightening monetary conditions. This was not the case in 2013. In fact, it could be argued that most of the major global central banks (including the Bank of Canada) were promoting easier monetary conditions at the end of the year than they did at the start.

While there are signs of economic improvement around the globe, considerable economic slack still exists and inflation is generally below central bank targets. In Canada, persistently high rates of unemployment and low inflation argue for a continued emphasis on monetary stimulus and this commitment has been clearly stated by Bank of Canada Governor Poloz.[7] The Fed also made the same sort of commitment. In the much anticipated press release from its December 18th meeting, the Fed indicated that a reduction of the exceptionally stimulative quantitative easing policies is at hand. However, it went to great lengths to underscore that there were still substantial risks to the economic recovery and that exceptionally low interest rates will continue well in to the future.[8] In our opinion, it may not be until 2016 that central banks begin to raise interest rates.

This commitment to keeping low official policy rates for some considerable future period is now well understood by the market and explains the stability of shorter maturity bonds in the last year. This change in the shape of the curve favoured portfolio positioning in shorter maturities – a strategy that we maintained throughout last year. As we consider the outlook for 2014, we continue to believe the best positioning for the portfolio is in shorter maturities, where the risk of capital loss in a rising rate environment is less material. The portfolio duration is 5.0 years, significantly less than the DEX duration of 6.9 years.

Using the bonds in our Nexus North American Income Fund as a proxy, this quarter our bonds again out-performed the modest returns of the DEX. Our fixed income holdings returned 0.8%, while the DEX returned 0.4%. In the last year, our bond holdings returned 0.8% against a *decline* in the DEX of 1.2%.



Government of Canada Yield Curve

Equities

For the nine months to September 30, equity investors had already achieved a better than average full-year equity market return. Nonetheless, the equity market roared ahead in the fourth quarter, delivering more than a full year's average return in just three months. Our Equity Fund was up 10.1% over that period and 22.1% for the year.[9]

After the strong run for equities, market valuation multiples are higher, but are not expensive, especially in this low interest rate environment. It will become more of a stock-picker's market, rather than a continuation of the "incoming tide lifts all boats" theme. We remain confident that our well-diversified

[7] Opening statement to the Senate Standing Committee on Banking, Trade and Finance. November 20, 2013.

[8] Board of Governors of the Federal Reserve Press Release. December 18, 2013.

[9] All the return data in the Equities section is for the Equity Fund. For more detailed performance, please refer to the Fund reports in this document or your client-specific report.

equity portfolio, with its dual characteristics of defensiveness and growth, is well suited to what is, and always will be, an uncertain future.

Canadian Equities

The Canadian equity market did exceptionally well in the most recent quarter. Our Canadian stocks were up 8.4% over the quarter and 17.8% for the year, outperforming the TSX Index. The Canadian market experienced an unusual year. The general theme was that equity investors are feeling better about the outlook, so cyclical sectors, such as Consumer Discretionary and Industrials outperformed, while the more conservative sectors, such as Utilities and Real Estate, did poorly. However, there were several sector-specific factors that affected the normal cyclical recovery pattern. Some cyclicals did not benefit. The Materials sector was decimated, down 29.1% for the year, driven by flame-outs in the Gold sector and a generally well-supplied metals market. The other typical cyclical recovery outperformer, the Energy sector, just kept pace with the overall market, as it struggled with oil pipeline bottlenecks, an oversupplied gas market, and cost pressures. Relative to the TSX Index, we benefited from not holding any Materials stocks.

Our strongest stocks over the year were Alimentation Couche-Tard, Thomson Reuters and CAE, with several other industrial stocks as strong followers. Alimentation Couche-Tard continues to execute well in the convenience store sector. Thomson Reuters has completed a major product transition and is seeing better growth. CAE had been scorned by investors for some time. Financially troubled airlines have not been able to renew their aged fleets and new aircraft platform launches have been delayed. This affects CAE, as new aircraft simulator orders are driven by aircraft deliveries. CAE has also experienced substantial costs as it re-configured and expanded its global network of aircraft simulators. Finally, its Military Simulation division has been subdued due to government fiscal constraints. These challenges are now receding and CAE's stock has responded.

We sold one small holding in the quarter, Enerflex, for a good gain. We continue to like its prospects, but, with portfolios typically overweight equities, we wanted to modestly reduce equity exposure.

U.S. Equities

Our U.S. equity portfolio had a fabulous run, up 15.6%[10] in the quarter and 37.0% for the year, slightly ahead of the S&P 500 in the quarter, but behind the index's huge 41.5% return for the year.

All U.S. equity market sectors did exceptionally well in 2013. The worst performing sector, Telecom, had a return of 19.2%! U.S. equity markets experienced a pro-cyclical rotation in 2013 in a similar, but cleaner, way than in Canada.

Our U.S. technology holdings performed especially well. Notably, Hewlett-Packard and Western Digital returned over 100% and Microsoft about 50%. The common thread across all our technology holdings is that they have been jettisoned by growth investors and had become attractively valued as a result. Notwithstanding the strong performance, all our technology holdings, including Cisco and Apple, remain attractively valued.

In the Consumer Discretionary sector, CarMax and Google were notable performers. CarMax is a leader in the recovering auto retail sector. Google has continued to grow profitably and confounded its many sceptics.

We sold Walter Energy in the quarter and took the tax loss. It has been a disappointment. But because it was the sole Materials holding in the overall (Canadian and U.S.) portfolio, we were able to avoid most of the carnage in this sector.

Other Equity Investments

We continue to carry two non-North American holdings within our Balanced and Equity Funds, which add beneficial diversity and potentially higher growth. These are two externally-managed pooled funds called EQIT (international developed market equities) and EMEC (international emerging market equities).

EQIT was up 8.0% for the quarter and 26.2% for the year. At this point, Europe is recovering, profit margins should expand from depressed levels, and valuation levels are more attractive than in North-America, all of which will be positive for EQIT.

After a difficult year for emerging markets, EMEC improved in the quarter, up 4.8%, but it was up only 2.8% for the year. We remain enthusiastic about EMEC's longer-term prospects. Despite higher growth, emerging markets trade at just 10.4x forward earnings and EMEC has a high quality-orientation within emerging markets.

[10] All U.S. and International returns are measured in Canadian dollars.

Pooled Fund Reports

Nexus North American Equity Fund

2013 will be remembered as a banner year for equity investors. The final quarter closed on a strong note with all global equity markets generating substantial positive returns. In the quarter the Equity Fund managed an advance of 10.1%, which was slightly ahead of the 10.0% advance of the Fund's benchmark.

Looking at the Fund by geography, while all markets were stronger, the U.S. market was especially strong – rising 14.3% in C$ terms. Our selections advanced 15.6%, and were our strongest asset class. The Fund's Canadian holdings also bettered the benchmark, rising 8.4%. The allocation outside North America produced mixed results. The EQIT Fund, which invests internationally in developed markets, returned 8.0%, as both European and Japanese markets were stronger. Our position in the EMEC Fund, which invests in emerging markets, was the weakest performing sector, producing a return of 4.8%. EMEC is a small position (3.7% of the total portfolio) and the long-term rationale for holding it remains intact. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review – Equity section of this report.

Somewhat counter-intuitively, for much of 2012 and 2013 equity investors (particularly those with a short-term horizon) have been unnerved by signs of economic recovery. They have feared that better economic conditions would prompt an increase in interest rates and a tightening of monetary conditions. While it's true that on their own, higher interest rates will deflate asset prices such as stocks, and act as a drag on interest rate sensitive sectors of the economy such as housing, autos and durable goods, a sustained rise in interest rates is only possible with an accelerating and durable economic recovery. Such conditions should be positive for corporate profitability and equity markets in the long-run. Sometime in the last quarter, the effect on markets of economic news seemed to revert to normal. Good economic news now actually fuels better equity market sentiment, and disappointing news has the opposite effect. It feels like a more normal, rational market, but it probably also means that there will be less opportunity to invest in a contrary manner than has been the case of late.

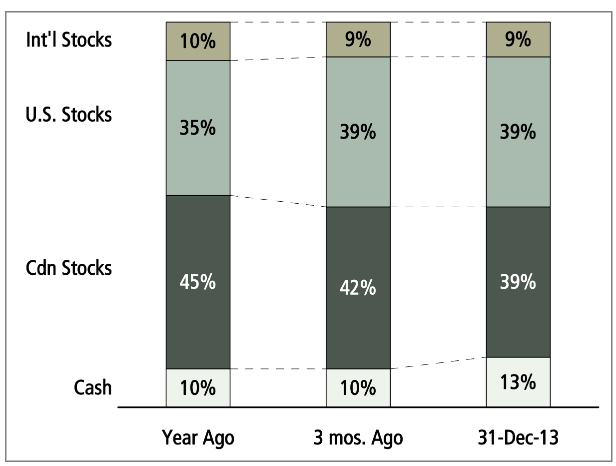
After having worked our cash position a little lower (to 10%) in the third quarter, it built back up in the last quarter to 13%. The cash has accumulated as a result of a combination of the receipt of dividends, as well as the proceeds of two small holdings that were liquidated in late November. It remains higher than target but ready to be put to work as opportunities arise. We maintained our allocation outside North America to just less than 9%. Our holdings of Canadian stocks, 39%, and U.S. stocks, 39%, remain equal at this point in time.

Returns for longer periods continue to exceed our benchmark and, most importantly, are attractive on an outright basis. The Fund has returned 22.1% in the last twelve months and has provided an annual average return of 8.6% for the last 10 years. More detail of the Fund's performance is laid out in the table below.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	10.1%	8.4%	15.6%	6.6%
Benchmark	*10.0%*	*7.3%*	*14.3%*	
One Year				
Fund	22.1%	17.8%	37.0%	16.1%
Benchmark	*24.5%*	*13.0%*	*41.5%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% DEX 91-Day T-Bill, 50% TSX, and 45% S&P 500 (in C$) (rebalanced monthly); (b) for Cdn Stocks: TSX; and (c) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at December 31, 2013



Equity Fund Asset Mix

Nexus North American Balanced Fund

2013 will be remembered as a banner year. The final quarter closed on a particularly strong note with all global equity markets generating substantially positive returns. Equity markets provided the lion's share of the good news, but even the bond market generated a small, positive return. In the last quarter the Balanced Fund managed an advance of 7.7%, which was slightly ahead of the 6.5% advance of the Fund's benchmark.

Turning first to equities, and looking at the Fund by geography, while all markets were stronger, the U.S. market was especially strong – rising 14.3% in C$ terms. Our own selections actually advanced 15.5%, and were our strongest asset class. Our Canadian holdings also bettered the benchmark, rising 8.1%. Our allocation outside North America produced mixed results. The EQIT Fund, which invests internationally in developed markets, produced a return of 8.0% as both European and Japanese markets in particular were much stronger. Our position in the EMEC Fund, which invests in emerging markets, was the weakest performing sector, producing a return of 4.8%. EMEC is a small position (2.3% of the total portfolio) and the long-term rationale for holding it remains intact.

As they did consistently throughout 2013, bond prices in the government of Canada market moved lower last quarter. Corporate and Provincial bonds declined less than Canada bonds, as the yield spread between these types of bonds and Canada bonds narrowed to their tightest level in a year. After taking into account the receipt of interest income, the DEX returned 0.4% and our bonds did better, returning 0.8% over the quarter. A more detailed explanation of developments in equity and bond markets appears earlier in the Asset Class Review section of this report.

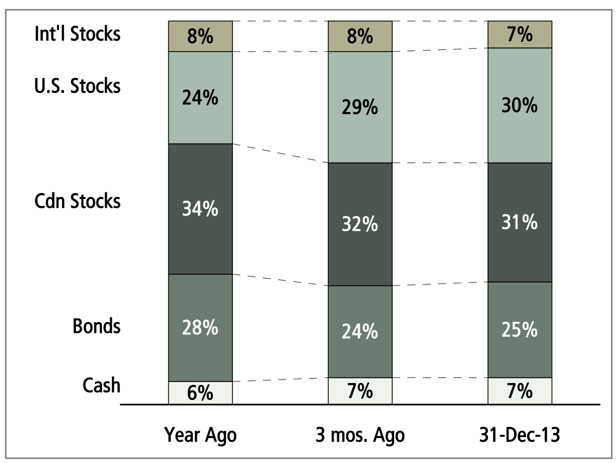
From an asset mix perspective, we made few changes to the relative weightings of our holdings. Our cash position of 7.5% remains slightly higher than the long-term guideline, the result of a combination of the receipt of dividends, as well as the proceeds of two small holdings that were liquidated in late November. We remain underweighted in bonds, with an allocation of only 25%. As a result, our total allocation to equities remains above target with most of the overweight distributed between our U.S. and Non-North American holdings.

Returns for longer periods continue to exceed our benchmark and, most importantly, are attractive on an outright basis. The Fund has returned 16.6% in the last twelve months and has provided an annual average return of 8.1% for the last 10 years. More detail of the Fund's performance is laid out in the table below.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	7.7%	0.8%	8.1%	15.5%	7.0%
Benchmark	*6.5%*	*0.4%*	*7.3%*	*14.3%*	
One Year					
Fund	16.6%	0.9%	18.3%	37.8%	18.6%
Benchmark	*14.4%*	*-1.2%*	*13.0%*	*41.5%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% DEX 91-Day T-Bill, 30% DEX Universe Bond, 40% TSX, and 25% S&P 500 (in C$) (rebalanced monthly); (b) for Bonds: DEX Universe Bond; (c) for Cdn Stocks: TSX; and (d) for U.S. Stocks: S&P 500 (in C$).

Investment Returns – As at December 31, 2013



Balanced Fund Asset Mix

Nexus North American Income Fund

By the standards of the bond market, the Income Fund had an exceptionally strong finish to 2013. In the quarter, the Fund increased 2.3% while the DEX returned only 0.4%. Over the last year, the Fund has managed a return of 4.6%, compared to a 1.2% *decline* in the DEX over the same period. More detail of the Fund's performance is laid out in the table below.

Although low in nominal terms, returns have been quite consistent and the Fund has delivered stability to investors for whom capital preservation is a priority. Returns over the last year and for longer periods continue to exceed our benchmark and the returns are substantially greater than inflation. Over the last 10 years, the Fund has provided an average return of 6.4% per annum.

As they did consistently throughout 2013, bond prices moved lower last quarter. Corporate bonds performed the best as spreads between these issuers and the government market continued to tighten. While some of the Fund's out-performance came from our bond positioning, most was derived from our allocation to 'Other Income-Oriented' securities. These holdings performed well as investors came to be comfortable with the notion that a reduction in monetary ease by the Fed is not the same as a tightening of monetary conditions. A more detailed explanation of developments in the bond market appears earlier in the Asset Class Review – Fixed Income section of this report.

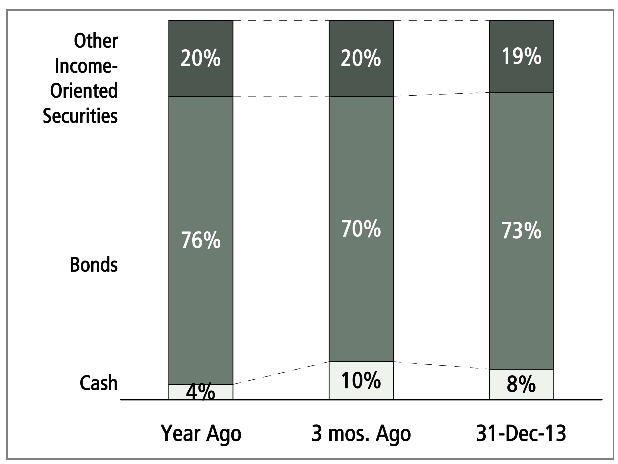
We continue to expect very moderate returns from our bond investments and better returns, albeit with greater volatility, from our allocation to 'Other Income-Oriented' securities.

Looking at asset mix, our subdued outlook for the return potential from fixed income has meant we remain under-invested in bonds, with an allocation of 72.5%, and we continue to have a substantial cash balance, 8.0%, that we think can be deployed back into the bond market when rates are higher. At 19.5%, our holding of 'Other Income-Oriented' securities remains at the Fund's practical limit.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	2.3%	0.8%	7.2%	15.3%
Benchmark	*0.4%*	*0.4%*		
One Year				
Fund	4.6%	0.8%	16.5%	45.4%
Benchmark	*-1.2%*	*-1.2%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: DEX Universe Bond; (b) for Bonds: DEX Universe Bond.

Investment Returns – As at December 31, 2013



Income Fund Asset Mix

Financial Market Summary

Market Levels

Canada	December 31, 2013	December 31, 2012
TSX Composite Index	13,622	12,434
91-Day T-Bill Yield	0.91%	0.93%
30-Year Government of Canada Bond Yield	3.24%	2.37%
Prime Rate	3.00%	3.00%
Exchange Rate (US$ per C$)	0.9402	0.9922
United States		
Dow Jones Industrial Average	16,577	13,104
Standard & Poor's 500 Index	1,848	1,426
30-Year U.S. Treasury Yield	3.97%	2.95%

Market Returns for Periods Ended December 31, 2013 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
DEX 91-Day T-Bill Index	0.3%	1.0%	0.8%	2.1%
DEX Universe Bond Index	0.4%	-1.2%	4.8%	5.2%
TSX Composite Index	7.3%	13.0%	11.9%	8.0%
S&P 500 Index (in C$)	14.3%	41.5%	14.7%	5.3%
MSCI EAFE Index (in C$)	9.3%	31.2%	9.3%	4.8%
MSCI Emerging Markets Index (in C$)	5.3%	4.1%	11.6%	9.0%

Notes:

[1] Market returns represent total returns, including income and capital appreciation (or depreciation).
[2] Market returns are compound annual rates for periods of more than 1 year, but are not annualized for shorter periods.