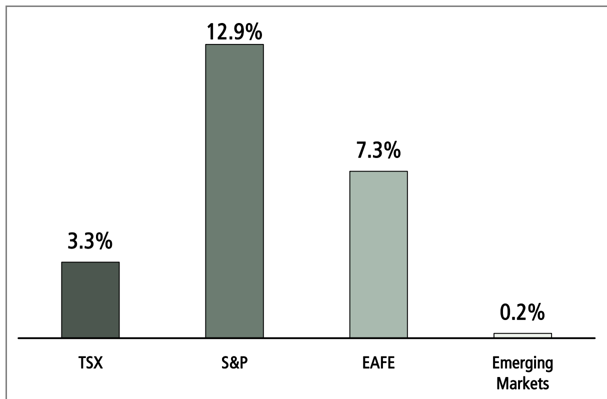
## A New, New Thing

This is the first publication of The Nexus Report. It is a product of our efforts to continuously improve the reporting we give to clients. We hope that you find that it provides our thoughts on the market outlook and a review of the quarter just passed in a streamlined and concise way, with less repetition than was found in the various reports we prepared in the past. We welcome any feedback you may have.

## A "Red Letter" Quarter

On the last day of the first quarter, both principal U.S. stock market indexes, the S&P 500 and the Dow Jones Industrial Average, closed at all-time highs. For the Dow, this was one of several new highs reached over the course of the quarter, but the S&P 500 moved higher much more reluctantly. Finally, on March 28, it was able to break through the previous high set back in 2007 before the credit crisis. While these milestones are not so important in isolation, they did reflect a strong stock market in the U.S. during the first three months of 2013. During the quarter, the Dow advanced 11.3%, its best Q1 performance in 15 years, while the S&P 500 Index rose 10.0%.[1]

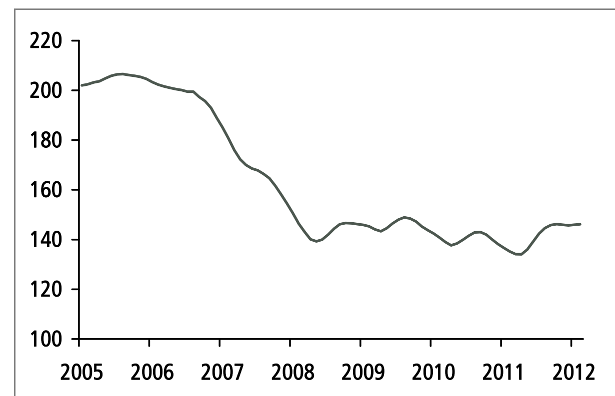



C$ Total Returns for Quarter Ended March 31, 2013

The performance of Canada's TSX Composite was more restrained, yet still generated a decent total return of 3.3% in the first quarter. While clearly not as impressive as the U.S. overall, many sectors of our market performed much better than this average. The big difference in the two markets is the ongoing poor performance of mining stocks, which constitute a significant part of the TSX.

[1] These are price-only returns in US$. The S&P 500 returned 10.6% in US$ on a total return basis and 12.9% in C$ terms.

In our view, the strength in markets during Q1 reflected many of the positive economic trends we have been discussing for several quarters. In the U.S., the recoveries in housing, construction and employment all continued. For example, house prices in all 20 markets tracked by the Case-Shiller Home Price Index rose in January, continuing a clear recovery from the low set in March 2012. These positive trends are important to help consumers repair their balance sheets that were so badly damaged in the 2008 credit crisis.




S&P/Case-Shiller Home Price Index [2]

In Canada, our strong dollar continues to generate headwinds for the manufacturing sector, and a number of other economic trends, like housing and retail sales, are weakening. However, investors also got some good news during the quarter. The rapid growth of personal debt, which has generated much concern over the last year, now seems to be moderating. Another positive is that evidence also points to the renewed growth of business credit, which acts as a fuel to power improved levels of economic output. As well, the recent federal budget has given investors comfort that improved federal finances are an important priority for the government.

While positive fundamentals are important for investor confidence, it is also important to recognize that financial engineering undertaken by central banks around the world remains a powerful force. In a recent report published by Merrill Lynch, analysts counted 503 interest rate cuts around the world over the last six years and calculated that central banks have injected US$11.6 trillion into their respective economies through the purchase of government bonds.[3] In our view, the liquidity from this central bank largesse may be as important as the economic

[2] Index of house prices in 20 urban markets in the U.S.

[3] *Barron's*, March 30, 2013.

fundamentals in explaining the strong stock market returns of the last quarter.

So powerful was the upward bias in markets during Q1 that several negative developments hardly rattled investors. For example, the quarter started with the U.S. stepping off of the Fiscal Cliff, only to be saved by a deal among lawmakers on New Year's Day. While this deal saved some of the existing tax reductions, it only deferred spending cuts to March 1, and now "sequestration" (as the spending cuts are referred to) is a fact of life. Overseas, the European debt crisis spread to the small island of Cyprus, which, much like Iceland in the credit crisis five years earlier was able to punch far above its weight in threatening to bring the global financial system to its knees. At other times, any one of these events might have sent investors scurrying for safety. In Q1 2013, however, investors took them in stride.

## A Gathering Storm?

Early in Q2 several dark clouds have appeared on the horizon and the sanguine mood that dominated Q1 has rapidly dissipated. Stock markets sold off noticeably in the first week of April.

In Canada, two separate economic releases stunned investors. The March employment report was universally described by economists as "ugly". Employment fell by 54,500 jobs, the worst monthly report in four years. If anything, details of the report were worse than the headline. Manufacturing was a particular weak spot and jobs in that sector have now declined in each of the first three months of 2013. The unemployment rate rose from 7.0% to 7.2%.

On the same day, Statistics Canada also reported that the February trade balance was a deficit of $1 billion, significantly worse than economists had forecast. Both it and the jobs report depict an economy that is struggling more than many had presumed.

In the U.S., the labour market report was also disappointing as non-farm payrolls grew 88,000 compared to expectations of approximately 200,000. Surprisingly, the unemployment rate actually improved to 7.6%; however, embedded in that apparent improvement is the most discouraging fact of all. The unemployment rate is the percent of the work force that is out of work. The "work force" is defined as those who have a job, plus those who are actually looking for one. The "participation rate" is the percent of the working age population in the "work force". In March, the participation rate was only 63.3%, the lowest level since May 1979. It seems that a huge number of able-bodied Americans have given up looking for work as they are so discouraged with their job prospects. One analyst estimated that if the participation rate was at more normal levels, the unemployment rate would be 11.5%.[4]

In the geopolitical sphere, investor worries have also intensified. Over the last several weeks the belligerent rhetoric coming out of North Korea has escalated to the highest level in years. It is easy to dismiss the threat posed by North Korea as it is a small and profoundly poor country, with a leadership that is so bizarre as to seem amusing. Yet it does have a documented nuclear capability and it is threatening to unleash that on the U.S. It's not entirely clear how it will do that given its limited military reach, yet the threat is real and worrisome. Any negative development in this region could send markets tumbling.

## Don't Throw Caution to the Wind

We look forward to the day when the outlook is sufficiently bright that we can throw caution to the wind. At present, however, we find ourselves faced by the same investment challenges that we have described for many quarters. In the short term there are a variety of risks – slowing North American growth and North Korea's sabre rattling are just two of them – that suggest to us that caution remains appropriate. Despite the very low level of interest rates, fixed income instruments are important in the portfolios of many investors to buffer against any hiccup in markets that could result from a negative development.

Looking to the long term, however, we remain of the view that the only asset class likely to give investors strong real returns is equities. In managing client portfolios we continue to search for the right balance between these short-term risks and the long-term objectives of our clients. It is never an easy balance to perfect, but we believe that by investing in the highest quality companies and taking a long-term perspective we can help clients weather any short-term disruption while exposing them to the long-term benefits that equity investing will provide.

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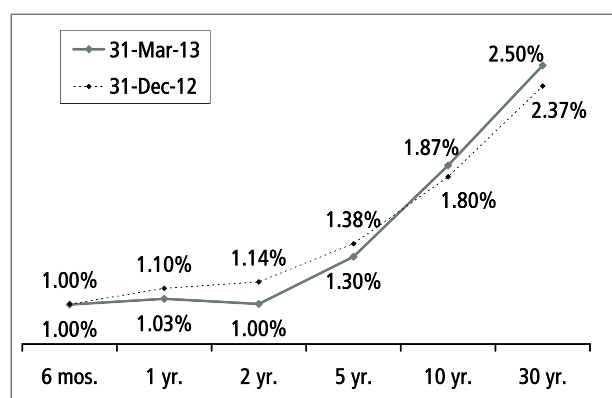
[4] *Barron's*, April 6, 2013.

# Asset Class Investment Review

## Fixed Income

Interest rates remain exceptionally low across the yield curve and were little changed over the course of the first quarter of the year. At the margin, there was some "steepening" of the yield curve. Yields of two-year securities declined 0.14% (14 basis points) and the yield of 10-year bonds increased 0.07% (7 basis points). As a result, the short maturity sector of the DEX Universe Bond Index (DEX) generated a return of 0.88% and the long maturity sector generated a loss of 0.25%.




Government of Canada Yield Curve

The dominant force in the bond markets remains the central banks – anchoring the front-end of the market with exceptionally low "policy" rates, and intervening with quantitative easing policies that pressure interest rates lower for longer maturities. This remains a global phenomenon and only the Bank of Canada among the G7 economies purports to consider that these highly stimulative conditions might need to be withdrawn sometime before the middle of the decade. Soft economic data and low reported inflation here in Canada have meant that an unwanted rise in inflation continues to be unlikely and, as a result, the Bank of Canada had to acknowledge in its latest Monetary Policy Report that "the timing of any such withdrawal is less imminent than previously anticipated."[5]

Staying in Ottawa for the moment, Finance Minister Flaherty introduced a budget in mid-March that affirms the commitment to balance the Federal budget by fiscal 2015/16. Despite a sluggish economy that will reduce tax revenues in Ottawa compared to earlier projections, spending restraint and the effect of ultra-low interest rates are creating better than projected savings for the Government. In the management of the Government's borrowing, Ottawa has announced that it will be lengthening the term of the debt in order to take advantage of the low interest rates currently available and to reduce the refinancing risk that comes from having too much short-term debt.

We support the Department of Finance's strategic intentions. It's an attractive time for borrowers and, correspondingly, a less attractive time for investors. Accordingly, we have kept the average maturity of our portfolio considerably shorter than the index (4.6 years duration vs. 6.9) and continue to emphasize good quality corporate bonds in order to earn extra yield. In fact, in the last quarter corporate bonds provided the best returns (+1.52%) due mostly to an average narrowing of their spreads over Canada bonds by 17 basis points.

We had good returns last quarter from our bond holdings. Using our Income Fund as a proxy, returns on bonds were 1.3% compared to the DEX return of 0.7%. In the last year our holdings have generated a 5.0% return which also compares favourably to the DEX's return of 4.5%.

## Canadian Equities

Equities have had a great start to the year. News headlines have been more equity-friendly than in a long time. After more than a three year hiatus, individual investors in North America finally started adding to Equity Funds. Indeed, the U.S. equity market returned a rip-roaring 12.9% for the first quarter and the MSCI World Equity Index was up 9.7% (all in C$). But for investors in Canadian equities …well, not so much. The TSX Index's total return for the quarter was 3.3%. Very respectable in its own right, but a pale comparison to the aforementioned returns. Talk about peer envy!

Our Canadian equities had market-like performance over the first quarter and are well ahead of the TSX for the past twelve months.

For the quarter, Canadian equity returns have been characterised by markedly different performance by industry sector and stock. To mention a few:

- The materials sector experienced very poor performance, with the Materials Index down 10.4% over the quarter – thankfully we have no holdings in this sector in Canada.

[5] Bank of Canada, Monetary Policy Report - January 2013.

- The energy sector is facing a number of challenges which are affecting our energy holdings, as well as holding back Canada's overall economic growth. Oil pipeline capacity constraints have resulted in Alberta crude oil selling at larger than typical discounts, natural gas prices remain stubbornly low, energy companies continue to experience cost inflation, and uncertainty persists regarding a possible carbon emissions tax.

- In financials, our Bank and REIT holdings were little changed. In effect, they "sat on the sidelines", after having done a sterling job during and after the credit crisis and we remain very comfortable with our picks.

A couple of stocks that have frustrated us for some time – BlackBerry and Thomson Reuters –put in solid recoveries. BlackBerry (the new corporate moniker for Research In Motion) finally launched its much delayed BB10 operating system at the end of January. Momentum is picking up for BlackBerry, with the rollout of its new Z10 smartphone and other new product launches on the way, but success is as yet nowhere near assured. For Thomson Reuters, two headwinds it has been facing – shrinking headcount in its principal end market (the financial sector) and a major product revamp – are abating.

Overall, we remain comfortable with our Canadian equity portfolio and recognise that, in a portfolio of good stocks for the long term, each stock cannot be a consistent performer every quarter.

## U.S. Equities

Our U.S. equity portfolio and the overall U.S. equity market continued to perform superbly, with our U.S. equities performing largely in-line with the S&P 500 over the quarter and year.

At the end of 2012, we reported that the S&P 500 (in C$) had outstripped the return of the TSX Index by almost 21 percentage points in total over the last two years. In Q1, the S&P 500 added another 9.6 percentage points to its return differential over the TSX. Quite the performance amidst all the angst around the Fiscal Cliff and the seeming inability of the U.S. political establishment to agree on anything! Over the past two years, we have increased our portfolio allocation to U.S. equities substantially, with the introduction of new names – CarMax, Google, Citigroup, JPMorgan Chase and Microsoft – and additions to existing holdings.

The ongoing recovery in the U.S. equity market has been broad based, but larger, stable, quality companies have done particularly well. The two strongest sectors in the quarter were Healthcare and Consumer Staples, where we are well represented with Covidien, Pfizer, DaVita and JM Smucker.

The U.S. financial sector has been healing steadily. Credit quality, loan growth, core earnings and capital ratios are all much improved. Valuation multiples, however, remain below historic levels – in part because the sector remains a target for regulators. During the quarter, in portfolios where weightings permitted, we added to our existing holdings of Citigroup and JPMorgan.

## Other Investments

We believe that international equity exposure is a value-added component for larger investment portfolios. We hold international equities in our Balanced and Equity Funds, as well as a number of segregated portfolios.[6] These holdings are in two third-party pooled funds managed by JPMorgan and include EQIT (international developed market equities) and EMEC (international emerging market equities).

Both pooled fund holdings had a positive return in the first quarter of 5.2% and 1.8% (in C$) respectively. EQIT is up 12.5% over the past year and EMEC is up 12.9% since we first established the holding in mid 2012.

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[6] The standard minimum investment for each of the international and emerging markets pooled funds is $150,000.

# Pooled Fund Reports

## Nexus North American Equity Fund

The Equity Fund began 2013 with a solid advance of 6.8%. All asset classes contributed positively to returns, with U.S. equities particularly strong. Over the last year, the Fund has generated a 10.9% return.

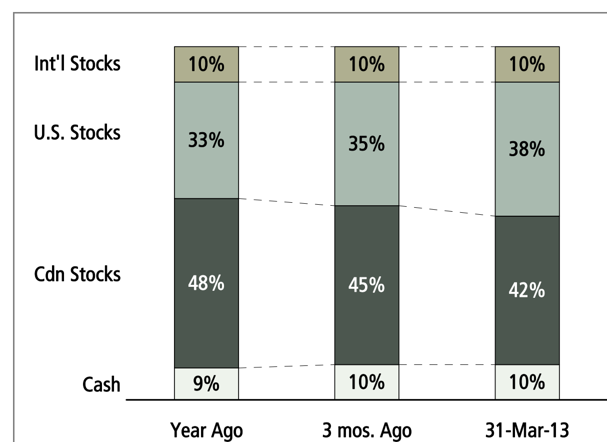
In buoyant markets, any allocation to cash acts as a drag on performance. This past quarter, as in the past year, we have generally maintained a 10% allocation to cash, rather than our long-term guideline of 5%. This positioning arises primarily from our caution regarding the short-term risks articulated earlier. We have preferred to maintain a small margin of defensiveness so that we are not fully invested in the event of a sudden market downturn and so we could take advantage of any bargains that might become available.

The current asset mix is little changed from where we ended 2012. There is a 90% allocation to equities and the balance is in cash. For the first time in many years the allocation outside of Canada is larger than our Canadian holdings. While Canada, with an allocation of 42%, still represents our largest weighting, U.S. stocks represent 38% of the portfolio, and our allocation to EQIT (non-North American developed markets) and EMEC (emerging markets) is 10%.

| | Equity Fund | Cdn Stocks | U.S. Stocks | Int'l Stocks |
|---|---|---|---|---|
| **Quarter** | | | | |
| Fund | 6.8% | 3.7% | 11.7% | 3.9% |
| *Benchmark* | *7.4%* | *3.3%* | *12.9%* | |
| **One Year** | | | | |
| Fund | 10.9% | 11.0% | 12.3% | 9.1% |
| *Benchmark* | *10.2%* | *6.1%* | *15.8%* | |

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 March 31, 2013




Equity Fund Asset Mix

## Nexus North American Balanced Fund

The Balanced Fund began 2013 with a solid advance of 5.1%. All asset classes contributed positively to returns, with U.S. equity performance particularly strong. Over the last year, the Fund generated a 10.2% return, again with strong performance from our U.S. holdings. These returns each compare very favourably to a benchmark created from underlying indices (as detailed in the table below). In fact, the Fund has outperformed its benchmark for one, three, five and ten year periods.

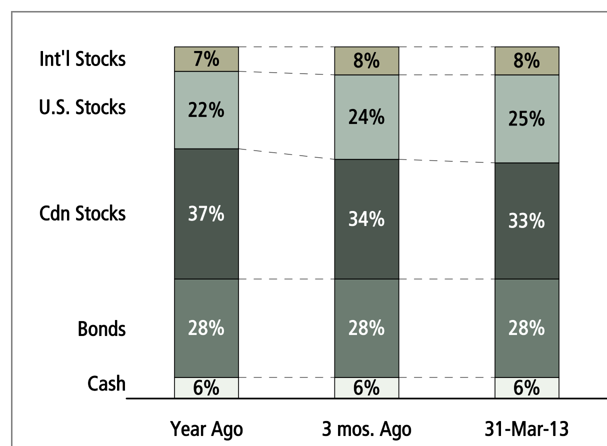
Our asset allocation to equities remains close to long-term guidelines. The positioning is little changed from where it was at the end of 2012. We have 66% of the Fund in equities, split almost evenly between Canadian and non-Canadian holdings. Bonds make up 28% of the Fund and the cash holding is 6%.

Despite strong equity returns over the last year, we think the opportunity for further long-term capital appreciation of our equity holdings remains. As we begin Q2, we expect to maintain the allocation between stocks and bonds close to the Fund's long-term guideline.

| | Balan. Fund | Bonds | Cdn Stocks | U.S. Stocks | Int'l Stocks |
|---|---|---|---|---|---|
| Quarter | | | | | |
| Fund | 5.1% | 1.3% | 2.9% | 12.0% | 4.1% |
| *Benchmark* | *4.7%* | *0.7%* | *3.3%* | *12.9%* | |
| One Year | | | | | |
| Fund | 10.2% | 4.4% | 10.7% | 15.0% | 9.5% |
| *Benchmark* | *7.9%* | *4.5%* | *6.1%* | *15.8%* | |

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 March 31, 2013




Balanced Fund Asset Mix

## Nexus North American Income Fund

The Income Fund began 2013 with a strong advance, gaining 2.4% over the quarter. This compared favourably to the return of the DEX Universe Bond Index (DEX) which generated a return of 0.7% over the same period. Out-performance came both from the allocation to "Other Income-Oriented" securities, which made a strong contribution, as well as better bond performance, with our bond portfolio returning 1.3%.

Looking back over the last 12 months, the Fund also out-performed the DEX, advancing 6.5% against the DEX's gain of 4.5%. In fact, we have out-performed the DEX for three, five and ten years.

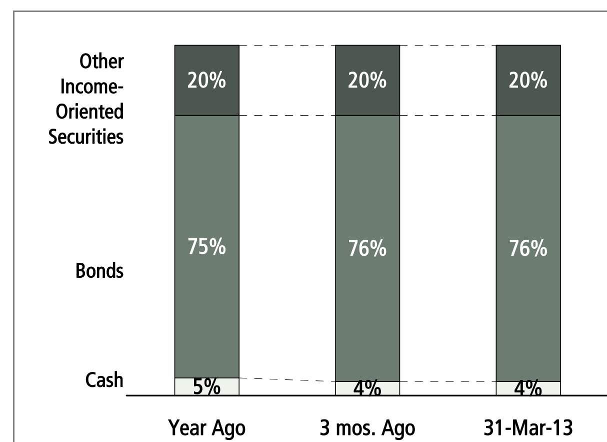
Due to the capital appreciation of the "Other Income-Oriented" securities, we have had to shave our holdings in order to stay below the 20% self-imposed limit for the Fund. Although it is tempting to relax the guideline and allow the allocation to creep higher, we think doing so would unnecessarily increase the potential for volatility in what is meant to be the most stable portion of a client's portfolio.

As we begin Q2, we expect to maintain the same strategic positioning: an overweight of quality corporate bonds, a maturity profile that is significantly shorter than the DEX and a large allocation to the "Other Income-Oriented" securities, where yields are higher and the chance of capital growth better than what's available in the bond market.

| | Income Fund | Bonds | Cdn Stocks | U.S. Stocks |
|---|---|---|---|---|
| **Quarter** | | | | |
| Fund | 2.4% | 1.3% | 2.6% | 12.3% |
| *Benchmark* | *0.7%* | *0.7%* | | |
| **One Year** | | | | |
| Fund | 6.5% | 5.0% | 11.7% | 18.8% |
| *Benchmark* | *4.5%* | *4.5%* | | |

Benchmarks are (a) for Fund: DEX Universe Bond; (b) for Bonds: DEX Universe Bond.

Investment Returns – As at March 31, 2013




Income Fund Asset Mix

# Financial Market Summary

## Market Levels

| | March 31, 2013 | December 31, 2012 |
|---|---|---|
| **Canada** | | |
| TSX Composite Index | 12,750 | 12,434 |
| 91-Day T-Bill Yield | 0.97% | 0.93% |
| 30-Year Government of Canada Bond Yield | 2.50% | 2.37% |
| Prime Rate | 3.00% | 3.00% |
| Exchange Rate (US$/C$1) | 0.9843 | 1.0051 |
| **United States** | | |
| Dow Jones Industrial Average | 14,579 | 13,104 |
| Standard & Poor's 500 Index | 1,569 | 1,426 |
| 30-Year U.S. Treasury Yield | 3.10% | 2.95% |

## Market Returns for Periods Ended March 31, 2013 [1]

| | Last Quarter | Last 12 Months | Last 5 Years [2] | Last 10 Years [2] |
|---|---|---|---|---|
| DEX 91-Day T-Bill Index | 0.2% | 1.0% | 1.1% | 2.2% |
| DEX Universe Bond Index | 0.7% | 4.5% | 5.9% | 6.1% |
| TSX Composite Index | 3.3% | 6.1% | 2.1% | 10.0% |
| S&P 500 Index (in C$) | 12.9% | 15.8% | 5.6% | 4.6% |
| MSCI EAFE Index (in C$) | 7.3% | 13.1% | -1.1% | 5.7% |

**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.