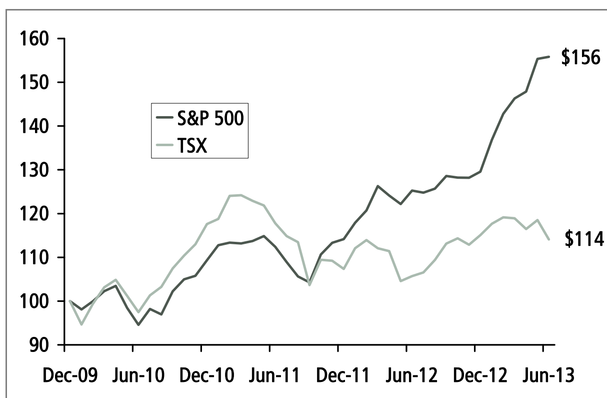
A Rising Tide

Turmoil returned to U.S. equity markets in June, but not enough to undermine what has been a fantastic stretch for investors in U.S. stocks. In fact, the Dow Jones Industrial Average climbed 13.8%[1] in the first six months of 2013, making it the most rewarding first half of a year since the halcyon days of 1999. Despite this generally positive tone, U.S. stocks did have a fairly sharp pull-back late in the quarter. Over a five week period starting in May, the S&P 500 declined 5.8% and many investors were rattled. Several concerns contributed to the down-draft, but the most significant was the U.S. Federal Reserve suggesting that improving economic conditions may allow it to "taper" its Quantitative Easing program in the fall. Recall that the Fed currently is purchasing $85 billion of U.S. Treasuries per month. The market reacted like a neurotic parent taking the training wheels off his or her child's bicycle for the first time. What if the child crashes? Thankfully, this market wobble was short-lived. During the last week of June and in early July U.S. stocks resumed their upward trend.



Growth of $100 Invested on January 1, 2010

The Canadian stock market has continued to lag the U.S. The first decade of the 21st century belonged to Canada as our market handily outperformed most developed markets. Since 2010, however, the U.S. has come roaring back. Over the last 12 months, the S&P 500 provided a return of 24.4% while the TSX returned 7.9%.[2] Over two years, the S&P is up 17.7% per year while the TSX is actually down 1.6% per year.

While these returns for Canadian markets overall are not encouraging, it is important to note that many companies and many sectors have performed well. For example, in the last 12 months, Canadian industrial stocks were up 25.6% and consumer stocks up more than 29%. In contrast, mining stocks, particularly gold mining stocks, have fared poorly. The gold sector is down 41.3% and base metal mining companies are down 19.5%. Over the last few years the Canadian investment experience was anything but homogeneous.

U.S. Gaining Strength

Most fundamental economic indicators suggest that the U.S. economy continues to gain strength. Since the 2008/2009 recession, the recovery in the U.S. has been one of the slowest ever recorded. Growth has been slow to return, but it is now gathering steam. Consumer confidence remains on a positive trend, and many housing market indicators are improving rapidly. For example, the Case-Shiller Home Price Index for April (released June 25) jumped 12.1% on a year-over-year basis, and posted the highest monthly increase ever recorded in the history of this index. More importantly, the June non-farm payroll report revealed that the U.S. economy created 195,000 jobs, slightly more than analyst expectations. As well, data for previous months were revised higher, confirming that the U.S. labour market continues on a positive trajectory. The only recent disappointments in the U.S. were the downward revision to first quarter GDP and an increase in the broader measure of unemployment (U-6[3]), which showed a jump in the 'under-employed' from 13.8% to 14.3%.

We expect that the U.S. economy will continue to improve and that economic growth there is likely to be a support for corporate earnings over the next year.

Canada Slow, But Steady

Canada's economic growth has slowed over the last several years, but remains positive and steady. It is interesting that a number of foreign investors have espoused quite dire outlooks for Canada, predicting a period of economic contraction ahead. We disagree. Many of the worries often pointed to are real – an extended housing market (particularly condos), high consumer debt, strong currency, weak productivity, and falling commodity prices – but we

[1] Returns in this paragraph are price-only returns in US$.
[2] Returns in the balance of this section are total returns in C$.

[3] The U-6 adds to the officially unemployed those who have taken part time jobs because they can't get a full-time one, and those who want a job but have given up looking.

don't believe recession is imminent. The U.S. is our largest trading partner, with 23% of Canadian GDP being exports to the U.S.[4], and the U.S. economy is improving. Quite simply, the U.S. can easily pull us along. Canadian economic growth is strongly correlated with that in the U.S. and never in history has there been a "made in Canada" recession. Recessions here have always started south of the border. As well, the Canadian dollar has weakened considerably over the last month, which should greatly help our export sector. It is true that Canadian personal debt levels are at disturbingly high levels, but higher down payment requirements, more responsible behaviour around loan documentation, and stricter conditions on mortgage repayment mean that it's unlikely that Canada will face a similar scenario to that which undermined U.S. banks in 2008 and 2009.

We do believe that U.S. growth is likely to be stronger than Canada's over the next few years, and that in Canada the most likely outcome is more of the same: slow but steady growth.

The Great Unknown

"The more things change, the more they stay the same" is a cliché as tired as any. Yet it endures as a way to describe the ever-changing array of geo-political uncertainties. For example, at the present time there is great social and political upheaval in Egypt that threatens to destabilize the Middle East and potentially disrupt oil supplies. Three months ago, Syria was the focus of investor angst for similar reasons. While conditions in Syria have not improved, Egypt now captures our attention.

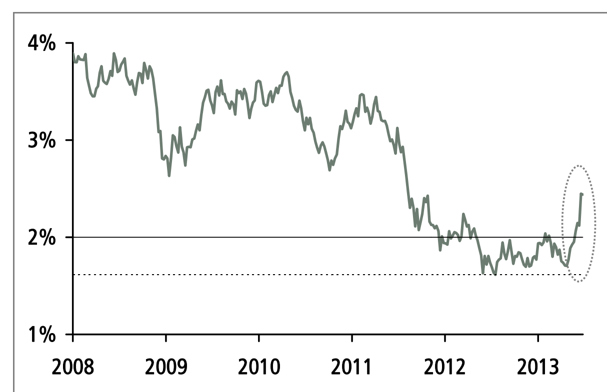
In Europe, economies remain mired in recession and tensions remain high between the relatively prosperous north and the very troubled south. We believe it will take years to work through Europe's problems, but the European Central Bank is working hard to stabilize the situation. In the last quarter, the government of Portugal nearly dissolved, continuing the cycle of crisis that previously had Greece, then Cyprus, as protagonists. None of these episodes has ended in disaster, but they constantly remind investors how precarious the European situation is.

In Japan, the Abe government has embarked on a radical series of reforms that are unprecedented in history. Its audacity has caught the attention of many, but also highlighted the unsustainable financial situation in Japan. A failure of "Abenomics" would spell serious trouble for the world's third largest economy.[5]

What all these risks have in common is the fact that they are unpredictable and largely outside an investor's ability to analyze. The probability of any one spelling trouble may be low, but any one of them could cause a chain of events that is very disruptive to markets.

Beginning of the Rotation?

One of the greatest bull markets in world history has been the bull market in bonds, which has persisted for more than 30 years. We have been premature in predicting its end, but it seems as though the great rotation out of bonds may have begun in the last two months.



Government of Canada 10-Year Bond Yield

For many investors, an allocation to bonds remains important as they still provide an element of stability to portfolios. However, common stocks offer the only avenue for the growth of real wealth over time. In the short term we continue to like the prospects for our holdings and think economic conditions are supportive for further earnings growth. A broad rotation from bonds to stocks would help as well. However, we are mindful that many risks remain in markets and volatility is likely to be somewhat higher in the second half of the year. Caution and conservatism remain important for the short term, but long-term investment opportunities are excellent.

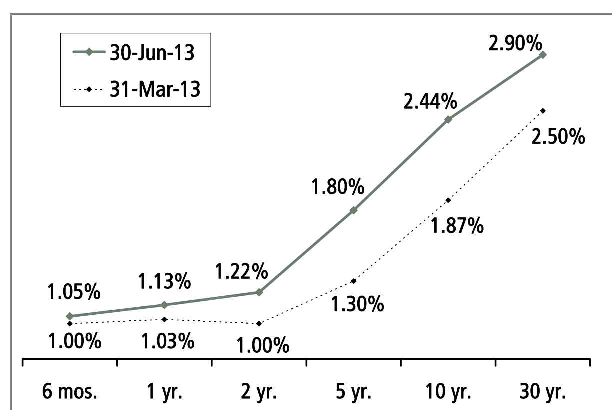
[4] "Woe Canada", Douglas Porter, BMO Capital Markets, July 5, 2013.

[5] Log onto the Nexus website and listen to our June Pooled Fund presentation for a more complete description of the challenges in Japan.

Asset Class Investment Review

Fixed Income

After many quarters spent preparing for higher interest rates, the long-awaited 'normalization' of interest rates in North America may have started. Ten-year Canada bonds finished the quarter at a yield of 2.44%, an increase of almost 60 basis points and well above their mid-May yield of 1.62%. They have continued higher since the end of Q2.

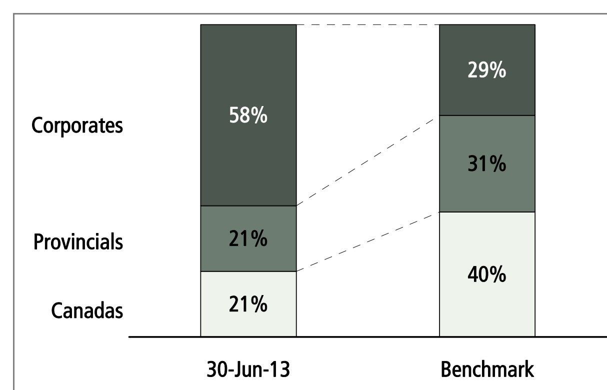


Government of Canada Yield Curve

In Canada, the rise in yields was neither driven by strong economic data, nor the prospect of the Bank of Canada (BoC) tightening monetary policy. On the contrary, economic conditions in Canada remain challenging and inflation is below the BoC's target range of 1% to 3%.[6] In fact, on May 29th, the BoC acknowledged that economic performance in Canada was subdued and that "the considerable monetary policy stimulus currently in place will likely remain appropriate for a period of time."

What pushed rates higher in Canada was higher yields in the U.S. Treasury market, a move prompted by Fed Chairman Bernanke's public comments about a tentative timetable under which the Fed would begin to taper the monetary stimulus it has been providing through its latest Quantitative Easing program (QE3). While it's hard to believe that such a preliminary discussion could have prompted such worry in capital markets, it's clear that easy money, provided by the Fed, has been supporting the purchase of riskier assets such as gold, commodities, stocks and even longer-dated U.S. Treasury securities. With the prospect that the end of easy money is nearer at hand, investors have begun to reduce exposure to these riskier assets.

To address such difficult conditions we continue to have three tactical aspects to our bond strategy. Firstly, the duration of our portfolio is 4.8 years, substantially less than the duration of the DEX Universe Bond Index (DEX) of 6.9 years. Secondly, in late May we reduced our exposure to the bond market and increased our cash position. As a result, we have been under-invested in bonds during this period of decline. Thirdly, we continue to overweight top-quality corporate bonds as a means of increasing the yield of our portfolio.



Bond Portfolio Composition

On a relative basis, our portfolio performed better than the DEX. Using the Nexus North American Income Fund as a proxy, our fixed income holdings declined 1.9% this quarter, while the DEX declined 2.5%. In the last year our bond holdings returned +1.2%, while the DEX returned -0.2%.

Equities

After a great start to the year, June turned into a rockier road for equity investors. As noted above, this was triggered by the U.S. Fed's musings on quantitative easing. Also, some pre-existing issues resurfaced – slower developing market growth, European instability, and Egypt. Nonetheless, most developed markets had positive returns for the full quarter, except for developing and commodity-oriented economies (including Canada).

Our equity portfolios held up well during the quarter. Over the twelve months, our Canadian and U.S. equity portfolios returned around +10% and +30%, respectively, and outperformed their benchmarks. After such a strong period in the equity markets, we

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[6] In the last three years, less that 20,000 new jobs have been created monthly and the annual growth rate of GDP has been less than 2% and steadily declining. The All-items CPI rose at a 0.7% annual rate for the 12 month period ending May 30, 2013.

anticipate that a market set-back, or at least a pause, is inevitable, but feel that it would be fruitless to try and trade around this.

As has been the trend for some time, our equity asset allocation to the U.S increased again over the quarter.

Canadian Equities

The quarter was a a tough one for commodity-oriented economies and the TSX Composite Index was down 4.1%. Our Canadian equities were down slightly, but did relatively better than the TSX.

Over the past twelve months, the TSX was up 7.9% for the year – respectable on its own, but well behind other developed markets. The performance of our Canadian equity portfolios, in the 10% range, was comfortably ahead of the TSX.

As occurred in Q1, Canadian equity returns in Q2 have been characterised by markedly different performance by industry sector:

- The two commodity sectors in the TSX (materials and energy) were hard hit. The materials sector had an abominable quarter, down 23%. We are entirely absent this sector in Canada, but note that we hold one materials stock in the U.S., Walter Energy, which has been badly damaged. This very limited materials exposure has helped performance. The energy sector, where we have several holdings, was down a more modest 3%. During the quarter we sold Talisman and reallocated the proceeds to other energy holdings. We have been patient with Talisman, as the company has changed management and re-focussed its strategy, but our other energy picks have a cleaner path ahead and are also attractively priced.

- The recent increase in interest rates has taken some of the wind out of the sails of income-oriented equities, with our telecom and utilities stocks trading down and a modest decline in our financials. In addition, our telecom holdings (Rogers and Telus) were hit by a tsunami of negative news in the sector. The CRTC imposed more consumer-friendly rules on the wireless carriers and, rather than the anticipated consolidation in the sector, it may become more competitive – the proposed Telus-Mobilicity deal was disallowed and the U.S. giant, Verizon, may enter the Canadian market.

- In contrast, it was a good quarter for our consumer staples holdings – Alimentation Couche-Tard (ATD) and Metro. ATD has completed its merger with Statoil Fuel and Retail, which gives it a solid footprint in Europe from which to grow. Also, Hess Corp has put its chain of over 1,300 U.S. convenience stores up for sale with ATD being a logical buyer with a disciplined acquisition track record.

U.S. Equities

The S&P 500 Index returned an attractive 6.5% over the quarter and put in an extraordinary performance of 24.4% for the twelve months (both in C$). An assist was provided by the Canadian dollar, which weakened by 3.4% over the quarter.

Our U.S. equity portfolio continued to perform very well, with our U.S. equities performing largely in-line with the S&P 500 over the quarter and well ahead for the year. Notwithstanding our disappointing holding of Walter Energy (as noted in the Canadian commentary above), Nexus U.S. equity portfolios returned around 30% over the past twelve months.

We hold a number of stocks in the technology sector, which has been out of favour and attractively priced for some time. Collectively, they put in the best Q2 return in our U.S. portfolio. We added to our long-suffering holding of Hewlett-Packard. Even after its share price recovery, it is still attractively priced and we are encouraged that HP's management is executing methodically on a multi-year restructuring plan. As the U.S. economy heals, our financials (JP Morgan and Citigroup) and consumer holdings (notably CarMax, Google and J.M. Smucker) have continued to do well. After a very strong run earlier in the year, our healthcare holdings treaded water in Q2.

Other Equity Investments

We continue to hold non North-American equities in our Balanced and Equity Funds, as well as a number of segregated portfolios.[7] These holdings are in two third-party pooled funds managed by JPMorgan called EQIT (international developed market equities) and EMEC (international emerging market equities). EQIT was up 2.5% for the quarter and a very strong 21.7% over the year. In a challenging developing markets environment, EMEC was down 3.4% in Q2, but up 9.1% for the twelve months (all in C$).

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[7] The standard minimum investment for a stand-alone investment in either of the international or emerging markets pooled funds is $150,000.

Pooled Fund Reports

Nexus North American Equity Fund

After a strong start to the year, market conditions were more challenging in the second quarter. Yet despite more difficult circumstances, the Equity Fund managed an advance of 1.8% which compares well to the Fund's blended benchmark return of 0.8% for the same period. Since the start the year, the Fund is up 8.8%.

Returns over the last year and for longer periods also exceed our benchmark and are attractive on an outright basis. The Fund has returned 17.3% in the last twelve months and has provided an average annual return of 8.7% for the last 10 years.

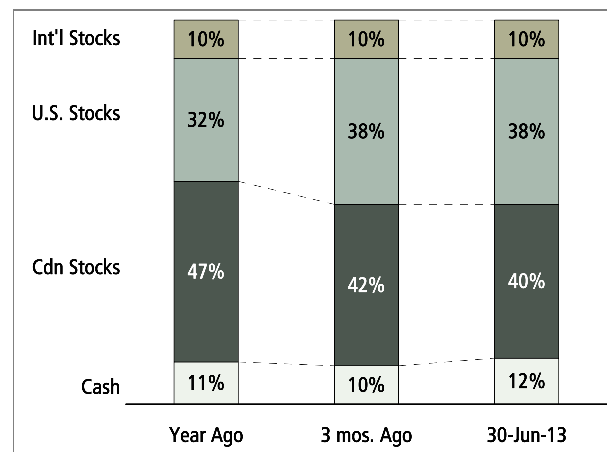
Once again in Q2, as has been the case for several years, the Canadian stock market underperformed the U.S. market. Canadian equity performance has been challenged by two major issues. First, signs of slowing growth in the emerging world (particularly China) have created a perception that growth in global commodity demand will weaken. Second, demand for gold as a safe haven has clearly declined. Over the course of the quarter, the price of gold declined almost 25% from US$1,600 to US$1,225 per ounce. Thankfully, the Fund has very little exposure to companies affected by these trends and so our Canadian performance continues to be notably better than the TSX Index.

From an asset mix perspective, there was a slight change to the allocation between stocks and cash since the last quarter. As has been the trend for a while, the Fund's Canadian stock allocation declined and there was a slight increase in both our U.S. equity and cash allocations. At 12%, cash is a little higher than we would expect to maintain, but it is ready to be put to work, as opportunities arise over the course of the summer.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	1.8%	-1.7%	6.6%	0.2%
Benchmark	*0.8%*	*-4.1%*	*6.5%*	
One Year				
Fund	17.3%	10.4%	29.7%	16.7%
Benchmark	*14.8%*	*7.9%*	*24.4%*	

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 June 30, 2013



Equity Fund Asset Mix

Nexus North American Balanced Fund

After a strong start to the year, market conditions were more challenging in the second quarter. Despite more difficult circumstances, the Balanced Fund managed a small advance of 0.9%, which compares well to the return of the Fund's blended benchmark which declined 0.7% for the same period. In the year to date, the Balanced Fund has returned 6.1%. More detail of our performance is laid out in the table below.

Returns over the last year and for longer periods also exceed our benchmark and are attractive on an outright basis. The Fund has returned 13.2% in the last twelve months and has provided an annual average return of 7.9% for the last 10 years.

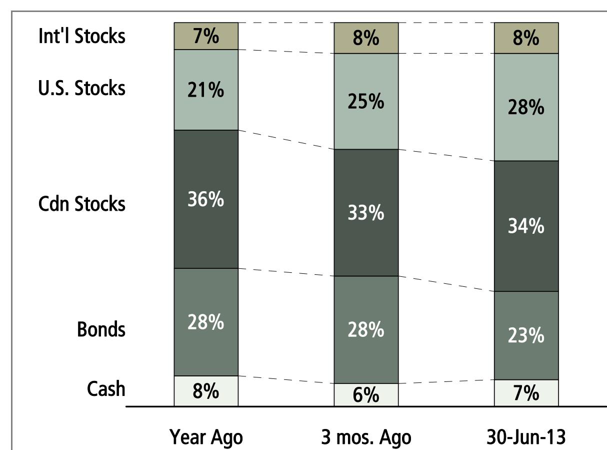
In the last quarter, bonds and Canadian stocks were a drag on investment performance. A sharp sell off in the bond market (discussed earlier in our Asset Class Review – Fixed Income) meant returns from the bond market were negative this quarter and the Canadian stock market also generated negative returns. Canadian equity performance has been challenged by two major issues. First, signs of slowing growth in the emerging world (particularly China) have created a perception that growth in global commodity demand will weaken. Second, demand for gold as a safe haven has clearly declined. Over the course of the quarter, the price of gold declined almost 25% from US$1,600 to US$1,225 per ounce. Thankfully, the Fund has very little exposure to companies affected by these trends and so our Canadian performance continues to be notably better than the TSX Index.

From an asset mix perspective, we made a tactical change to the portfolio this quarter that is worth noting. In late May, we lowered the allocation to bonds from 28% of the portfolio to 23%. This is substantially below the Fund's long-term guideline of 30% and reflects our belief that interest rates will continue to increase. However, it also reflects our belief that there is better relative opportunity in the equity markets and most of the money raised from the sale of bonds was allocated to equities, primarily in the U.S.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	0.9%	-1.8%	-1.5%	7.1%	0.7%
Benchmark	*-0.7%*	*-2.4%*	*-4.1%*	*6.5%*	
One Year					
Fund	13.2%	1.3%	10.8%	31.0%	17.7%
Benchmark	*9.0%*	*-0.2%*	*7.9%*	*24.4%*	

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 June 30, 2013



Balanced Fund Asset Mix

Nexus North American Income Fund

After a strong start to the year, market conditions were more challenging in the second quarter and the Income Fund declined by 1.4%. This compares well to the return of the benchmark DEX Universe Bond Index which declined by 2.4% for the same period. In the year-to-date, the Income Fund has managed a small positive return of 0.9%. More detail of our performance is laid out in the table below.

Returns over the last year and for longer periods also exceed our benchmark. Although low in nominal terms, they have been quite consistent and have delivered stability to investors for whom capital preservation is a priority. The Fund has returned 3.8% in the last twelve months and has provided an annual average return of 6.3% for the last 10 years.

A sharp sell off in the bond market (discussed earlier in our Asset Class Review – Fixed Income) meant returns from the bond market were negative this quarter. Returns from our allocation to 'Other Income-Oriented' securities also generated negative returns.

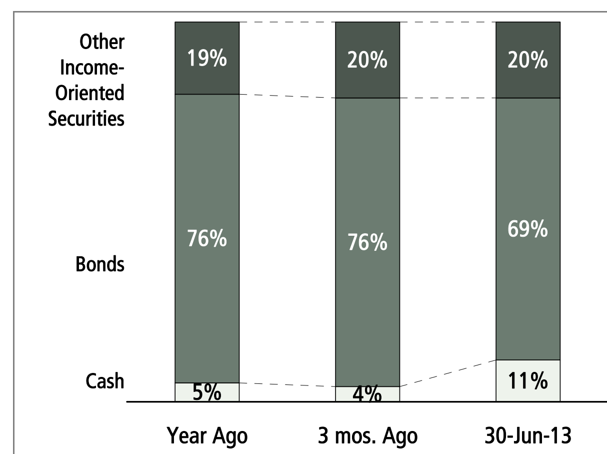
Weakness in bond markets was not a particular surprise, but we were somewhat surprised by the degree of weakness in our holding of "Other Income-Oriented" securities. While there is an obvious sensitivity of higher dividend-paying stocks to rising interest rates, for now we think the market has over-reacted. We would stress that the companies we own are not simply high-dividend paying entities, but rather companies whose businesses generate consistent, growing earnings that offer the prospect of growing dividends over time. We took advantage of share price weakness to add to several positions, such that the Fund is, effectively, at its 20% limit for this asset class.

From an asset mix perspective, we made a tactical change to the portfolio this quarter that is worth noting. In late May, we lowered our allocation to bonds from 76% of the portfolio to 69%. This is substantially below the Fund's long-term guideline and reflects our belief that interest rates will continue to increase and that there will be a future opportunity to put cash to work at higher yields.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-1.4%	-1.9%	-2.7%	12.0%
Benchmark	*-2.4%*	*-2.4%*		
One Year				
Fund	3.8%	1.2%	9.5%	27.2%
Benchmark	*-0.2%*	*-0.2%*		

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 June 30, 2013



Income Fund Asset Mix

Financial Market Summary

Market Levels

	June 30, 2013	December 31, 2012
Canada		
TSX Composite Index	12,129	12,434
91-Day T-Bill Yield	1.02%	0.93%
30-Year Government of Canada Bond Yield	2.89%	2.37%
Prime Rate	3.00%	3.00%
Exchange Rate (US$/C$1)	0.9508	1.0051
United States		
Dow Jones Industrial Average	14,910	13,104
Standard & Poor's 500 Index	1,606	1,426
30-Year U.S. Treasury Yield	3.52%	2.95%

Market Returns for Periods Ended June 30, 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%	1.0%	2.2%
DEX Universe Bond Index	-2.4%	-0.2%	5.5%	5.3%
TSX Composite Index	-4.1%	7.9%	-0.5%	8.4%
S&P 500 Index (in C$)	6.5%	24.4%	7.7%	4.6%
MSCI EAFE Index (in C$)	2.5%	22.4%	0.0%	5.0%

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.