NEXUS

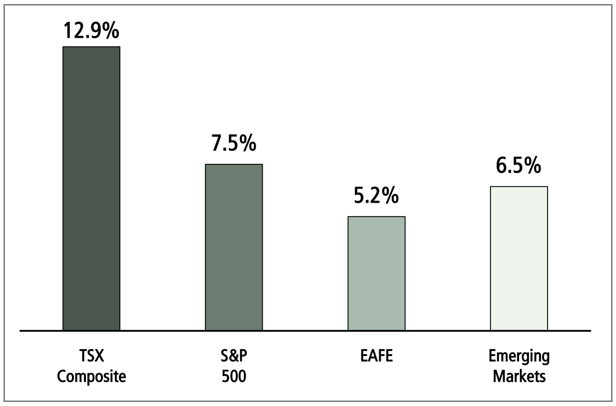
Portfolio Management & Financial Counsel

THE NEXUS REPORT

Second Quarter, 2014

Oh, Canada!

As we celebrated July 1, Canadians had more to be grateful for than 147 wonderful years of our nation's history. Those attuned to financial markets also celebrated the fact that Canada's principal stock market index, the TSX Composite, was the best performing major stock market in the world in the first half of 2014.[1]



Total Returns (C$) for 6 Months Ended June 30, 2014

Natural resource stocks, both energy and mining, were the belles of the ball in a Canadian market that saw gains across all sectors. This is particularly significant as these two sectors make up 39.4% of the Canadian stock market, a far heavier weighting than in most other markets. After a somewhat rocky 2013, investors flocked to resource stocks as commodity prices strengthened over the course of this winter and spring. Moreover, the prices of commodities specifically produced in Canada gained even more than the average represented by the Commodity Research Bureau basket.

Good times were not limited to Canadian investors, however, as markets around the world have continued to climb higher. As the graph above illustrates, returns in the U.S. and in international markets were all strong, reflecting improved economic trends and a period in which spirits were not dampened by geopolitical worries.

U.S. Economic Curve Ball

In the April *Nexus Report*, we recognized the significant challenges that extreme winter weather posed to U.S. economic growth. We also reiterated our belief that the U.S. economy would sustain its upward momentum despite a short-term blip. We agreed with the consensus view in early April that first quarter growth likely would slow to the fairly weak level of 1.2%. While expectations for the pace of growth deteriorated during the quarter, it came as quite a shock in late June when first quarter GDP growth was revised dramatically lower to -2.9%. This alarmingly weak performance typically occurs when an economy is plunging headlong into recession. Were we too sanguine about the outlook for the U.S. economy and markets?

In our view, the drop in GDP, while surprising, is not the harbinger of another recession. In addition to the extreme weather in the first three months of the year, there were several other one-time events that weighed on economic growth. For example, there was a 1.4% drop in health care spending as a result of the Affordable Care Act (a.k.a. Obamacare) coming into effect.[2] The weather, Obamacare, and various other one-time events conspired to throw a temporary wrench into the economy's gears.

It is also important to note that GDP stands as one of the few economic indicators that suggests weakness in the U.S. – most other economic reports over the last quarter have been strong. The labour market remains a bright spot, as the report for June showing 288,000 new jobs created was even better than investors' high expectations. Along with this came small upward revisions for hiring in previous months, as well as a drop in the unemployment rate to 6.1%. The ISM purchasing managers index is strong, signalling solid economic growth ahead, and consumer confidence remains at good levels. New home sales in May rose 18.6%, the largest gain in 20 years. Despite the curve ball that negative first quarter GDP growth threw at investors, we believe that the U.S. economy continues to improve and, over the balance of the year, should provide a solid backdrop for corporate profits.

Canadian Economy Struggles

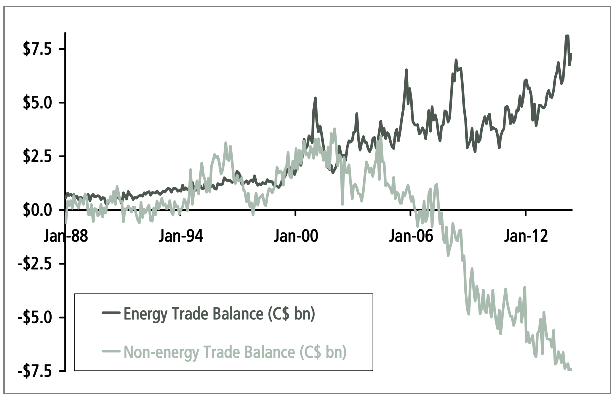
While first quarter GDP growth in the U.S. was surprisingly negative, the report for Canada turned out to be exactly as expected: a weak positive. The lacklustre growth rate of 1.2% remains very disappointing. The Canadian economy just can't seem to gain traction.

[1] In truth, Italy was better, but a debate rages as to whether the Italian stock market is "major".

[2] *Barron's*, June 28, 2014

Perhaps the most vivid expression of weakness in the Canadian economy can be seen in the labour market. Despite an apparent healthy gain in May (25,800 new jobs) all the gains were in part-time positions. The number of full-time jobs actually declined year-over-year, a situation that is extremely rare in non-recessionary periods. In total, the Canadian economy has generated fewer than 30,000 full-time jobs over the last 18 months, a hugely disappointing performance. Also crucial to understand is that 83% of the new jobs created in the last 12 months were in Alberta, a province with only 11% of the national workforce.[3] It's not a pretty picture in many other areas of the country.

Canada's trade situation reflects a similar dichotomy. The chart below separates our balance of trade in energy from the balance of trade in everything else. Over the last 10 years these trends have gone in opposite directions: our exports of energy have soared and our exports of everything else have languished.



Canadian Trade Balance (C$ millions)

The Canadian economy continues to muddle along, with one's perception of vitality varying dramatically from region to region. We remain hopeful that better times lie ahead as the U.S. recovery accelerates. Since 70% of our exports go to the United States, improvement there should migrate here. However, we may need an added boost from a lower Canadian dollar as well.

Complicated Times

A growing chorus of experienced investors has described the current environment as the most confusing of their career. On one hand, there are many reasons for caution. One respected measure of market valuation – Robert Shiller's cyclically adjusted price-earnings ratio – is flashing a danger sign. Based on its methodology, the U.S. market is trading at 26x earnings, far above its average of 17x since 1881. It only has been above current levels three times in history: 1929, 2000, and 2007. Picking up on a similar theme, the Bank for International Settlements, sort of a global central bank, has sounded a warning. It indicated in its recent annual report that it believes that "euphoric" financial markets have become detached from economic reality. The unprecedented monetary policies being pursued by central banks around the world have inflated financial asset prices to high levels. It worries another stock market bubble is being formed.

On the other hand, most traditional measures of stock valuation suggest that markets may be fully valued based on historic averages, but not excessively so. In fact, other asset classes offer cause for greater concern. In particular, interest rates remain at historic lows in North America and are actually *negative* for certain deposits in Europe. While the timing of a rise in rates is uncertain, it is undeniable that they will move higher in time.

So what is one to do? In the short term it is tricky and many investors are gnashing their teeth. The current bull market in the U.S. has passed the 63 month mark, compared to an average of 58 months for the 11 bull markets in the post-war period.[4] Surely it is time for a correction. The reality is that most market disruptions do not arise just because the market is "pricey", but are caused by events that are unexpected, such as a political crisis or international conflict. Over the balance of 2014, we believe that the most likely path is for the U.S. recovery to gain steam, and for earnings to grow. In this environment, markets are likely to remain healthy.

As long-term investors thankfully we do not have to worry so much about short-term gyrations. Accordingly, with some caution, we remain fully committed to equities. Over the long term, we are confident that the companies in which we are invested will prosper and grow. As earnings grow, so will stock prices. Stock prices won't rise in a steady and consistent manner. They never do. But we remain confident that in time, even from current levels, clients will be properly rewarded for their investment in good companies.

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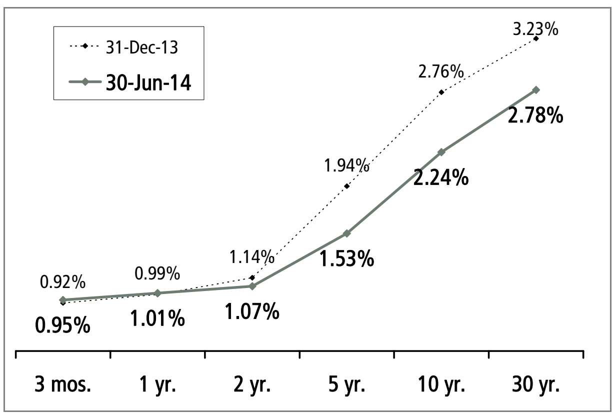
[3] This is both full-time and part-time jobs. 71,200 of 85,500 created were in Alberta.

[4] *Barron's*, June 28, 2014

Asset Class Investment Review

Fixed Income

The unexpected decline in bond yields that began in the first quarter continued in the second. While the improvement in the bond market was not large, it was widespread. Yields declined almost 20 basis points (0.20%) for all maturities longer than two years. In addition, the trend of narrowing corporate spreads also continued. In the second quarter, the FTSE TMX Bond Universe Index[5] (the "Bond Index") generated a 2.0% return. Our returns, using the bonds in the Nexus North American Income Fund as a proxy, slightly lagged this result, producing a 1.6% return. So far this year, our bonds have generated a 4.2% return as compared to the Bond Index return of 4.8%. Our returns for longer periods continue to exceed the Bond Index.



Government of Canada Yield Curve

Surprisingly, yields have now fallen back to their lowest level in a year, a development that typically would be associated with a softening of economic growth or a decline in the level of inflation. In fact, while economic performance has been underwhelming, we see ample evidence of continued improvement in both Canada and the U.S. and a clear path to faster growth for the balance of 2014. With respect to inflation, in both countries there has been a noticeable pick-up, perhaps presaging a return of some pricing power and a tightening of economic slack. Since the beginning of the year, the Canadian inflation has increased from 1.2% per annum to 2.3%, above the midpoint of the Bank of Canada's target range of 1% to 3%. Likewise, U.S. inflation has accelerated from just more than 1% in January to 2% currently.

To be clear, we are neither forecasting nor positioning for a scenario of rapidly accelerating growth and runaway inflation. Rather, our view of the macroeconomic backdrop continues to be of a moderate recovery that will reduce economic slack and lead to some upward pressure on inflation. In such a scenario, by late 2015 central banks will want to reduce the amount of monetary stimulus in the economy and begin to normalize the general level of interest rates.

If the economic facts are inconsistent with the recent trend in bond yields, what then is driving the bond market? While it can't be proven with certainty, there is some evidence that powerful, but temporary, technical factors are largely to blame. The most notable of these is the role of central bank policy in Europe. In response to soft economic conditions across the Eurozone, the European Central Bank is now pursuing a negative interest rate policy – charging banks to leave money on deposit there. Government bond yields in Europe have declined as a result. At 2.60%, Spanish 10-year bonds yield about the same as US Treasuries, while French bonds yield 1.70% and German rates for the same term are 1.25%. AAA-rated Government of Canada 10-year bonds yielding 2.25% look attractive by comparison! This relative attractiveness is corroborated by recent International Monetary Fund showing a sharp increase in the holdings of Canadian dollar bonds in the reserves of central banks that disclose their holdings. We know from our contacts in the dealer community that accumulation of Canadian dollar bonds by foreign central banks has continued this quarter.

We have maintained our strategy of concentrating the portfolio in maturities between three and ten years and emphasizing issuers with strong credit quality. While low absolute interest rates continue to generate a frenzy of corporate borrowing, allowing even companies of questionable credit quality access to cheap capital, we have no bonds below investment grade, and less than 1% of the portfolio in bonds rated BBB. If we are correct, and economic growth continues over the course of the coming year, investors will begin to concern themselves with a change in central bank policy that emphasizes restraint rather than stimulus. In such a scenario, our focus on quality and shorter duration holdings should be well rewarded.

5 Formerly the DEX Universe Bond Index

Equities

Thus far, 2014 has been an excellent year for equity investors around the globe. Despite a range of worries, markets have climbed higher relentlessly. As an indicator, our Equity Fund was up 8.4% in the first six months of 2014 and 21.8% over the past twelve months.[6]

Last quarter we remarked that market valuation levels in North America are no longer cheap. With the continued rise in equity prices in this past quarter, valuations also have increased further. While we don't yet see these levels as extreme, they result in an outlook for returns for the next year that is more muted than it was.

Canadian Equities

Nexus Canadian stocks were up 4.5% in the second quarter and are up 25.3% over the last year. While these are excellent results, they do trail the returns generated by the TSX Composite. The TSX returned 6.4% during the quarter and 28.7% in the last year. Our shorfall is explained by sector weighting; specifically, that we have less invested in the natural resource sector than does the Index. Over the last year, Energy was the best performing sector in the TSX. Our Energy stocks did even better than the sector average, but we are underweight relative to the hefty weighting of these stocks in the Index. (Energy comprises over 27% of the TSX.) Sectors where we are overweight were good, but not as good as Energy. More recently, mining stocks have also been one of the leading sectors in the TSX. We own no mining stocks in the portfolio.

Shares of ATCO were a new addition to the Canadian equity portfolio during the last three months. ATCO is an Alberta-based holding company whose major asset is a 53% interest in Canadian Utilities. While many utility stocks offer rich valuations and slow growth, we think ATCO presents an unusual and attractive opportunity. Being focused on Alberta, it is exposed to the fastest growing region for infrastructure spending in North America. At the same time, it trades at a material valuation discount to most utilities, including its own subsidiary, Canadian Utilities. We believe the reason this opportunity exists is because of ATCO's complicated corporate structure and the limited liquidity of it shares. As a long term investor we are less concerned about liquidity, and we are excited by situations where our detailed analysis leads to great opportunities!

U.S. Equities

The S&P 500 trailed the TSX significantly in the last quarter, but Nexus's U.S. holdings were outstanding. Our stocks returned 3.3%[7] in the quarter and 26.6% for the twelve months, well ahead of the S&P 500's 1.6% in the quarter, and identical to the S&P return for the twelve months.

Our success during the quarter resulted from good performance across a wide range of our holdings. Most notable was the announced merger of long-time holding, Covidien, with Medtronic, another leading medical devices company. The transaction resulted in a substantial jump in Covidien's share price thanks to the favourable terms for Covidien investors. Part of the motivation for this transaction is the so-called tax "inversion", where Medtronic will benefit from Covidien's low corporate tax rate (thanks to its Irish domicile). More than that, there is a sensible rationale for combining the businesses and our intention at the present time is to stay invested in the new combined entity.

Several other stocks also were strong performers, including Apple and Carmax, which both reported surprisingly strong quarterly results during the quarter. Investors quickly surmised that the growth potential of each may have been underestimated. For Apple, there seems to be a growing consensus that it could be on the cusp of a strong new product cycle in the fall, led by the launch of iPhone 6.

Other Equity Investments

We continue to hold two non-North American equity investments within our Balanced and Equity Funds. Each is expected to add beneficial diversity and higher growth potential over the long term. These are two externally-managed pooled funds called EQIT (international developed market equities) and EMEC (international emerging market equities).[8] Returns from both of these funds have been good over the last year, but not quite as good as our North American equities.

EQIT was up 0.4% for the quarter and 21.0% for the last twelve months. EMEC continued its strong recent performance, generating a return of 3.0% in the quarter. EMEC is up 12.4% in the last year.

[6] All the return data in the Equities section is for the Equity Fund. Equity returns within the Balanced Fund were similar, but for more detailed performance, please refer to the Fund reports in this document or your client-specific report.

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

[8] Both funds are managed by teams from JP Morgan Asset Management based in London.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus Equity Fund had another strong quarter. While returns in the first quarter had been assisted by a slide in the Canadian dollar, this effect reversed in the more recent quarter, detracting from returns for investments outside of Canada. In the quarter the Equity Fund managed an advance of 3.2%, which trailed the 4.0% advance of the Fund's benchmark.

Returns remain well balanced across different geographies, but Canadian results were particularly strong. The Canadian holdings increased 4.5%, but trailed the TSX Index which rose 6.4%. In the U.S., our holdings advanced 3.3%, bettering the 1.6% generated by the S&P 500. The allocation outside North America produced positive, but less favourable results. The EQIT Fund, which invests internationally in developed markets returned 0.4%, and our position in the EMEC Fund, which invests in emerging markets, continued its strong recovery, advancing 3.0%. Together, EQIT and EMEC represent about 10% of our total equity exposure. A detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

After advancing more than 20% in the last 12 months, it is hard not to be somewhat cautious about market prospects for the balance of the year. We know however, that the best approach for long-term success remains in assembling a diversified portfolio of good businesses at sensible valuations with some aspect of defensiveness in the way they are managed. This approach removes the temptation to "time" markets, which has proven to deliver poor results. In strong markets, our high-quality approach can lead to a degree of underperformance, but it more than makes up the difference by providing less downside in weak markets.

That said, a consequence of such strong recent performance is that it has become tougher to find new ideas at attractive valuations. At Nexus, it has been a busy quarter of analyst, conference and company visits. There has been a strong emphasis on uncovering new candidates as well as confirming the investment thesis of current holdings. Low portfolio turnover has the benefit of forestalling the recognition of capital gains, but in an eligible universe as large as ours, we are always hopeful of uncovering new and better ideas for the portfolio.

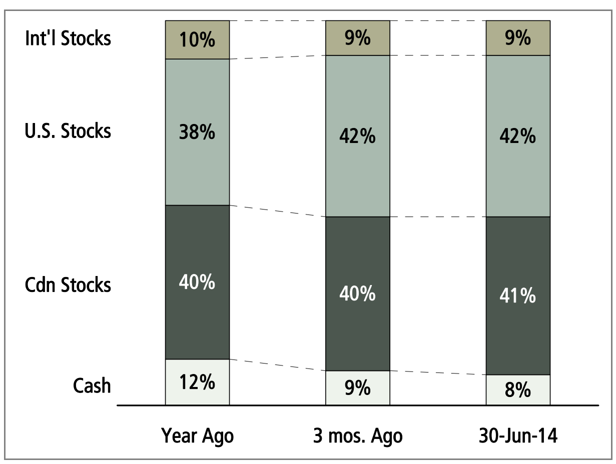
The cash position is 8%, as it was at the start of the quarter. These monies remain ready to be put to work as we find investments that we feel have long-term appeal. Our allocation to Canadian stocks (41%) and U.S. stocks (42%) remains roughly equal and we still have 9% invested outside of North America through our holdings of EQIT and EMEC.

Returns for longer periods continue to be excellent. The Fund returned 21.8% in the last twelve months, lagging the blistering 26.3% return of our benchmark. More importantly, the Fund has provided an annual average return of 8.8% for the last 10 years, a substantial increment above the 7.1% return from the benchmark.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	3.2%	4.5%	3.3%	1.6%
Benchmark	*4.0%*	*6.4%*	*1.6%*	
One Year				
Fund	21.8%	25.3%	26.6%	17.5%
Benchmark	*26.3%*	*28.7%*	*26.6%*	

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, 2014



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund advanced 2.7% this quarter. While equities provided most of the gain, bonds continued the strong performance that they delivered in the first quarter. These results trailed our benchmark, which advanced 3.6%.

Turning first to equities, returns continued to be well balanced across different geographies. However, Canadian results were particularly strong. The Fund's Canadian holdings increased 4.5%, but trailed the TSX Index which rose 6.4%. In the U.S., our holdings advanced 2.9%, bettering the 1.6% generated by the S&P 500. The allocation outside North America produced positive, but less favourable results. The EQIT Fund, which invests internationally in developed markets returned 0.4%, and the EMEC Fund, which invests in emerging markets, continued its strong recovery, advancing 3.0%. Together, EQIT and EMEC represent about 10% of our total equity exposure. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

It was more of the same in the bond market this quarter, with yields declining and the spreads between corporate and government bonds continuing to contract. Rates are now at their lowest level in the last year and, as a result, have generated surprisingly good returns in 2014. Over the most recent quarter, the Bond Index generated a 2.0% return, somewhat ahead of our returns of 1.7%. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

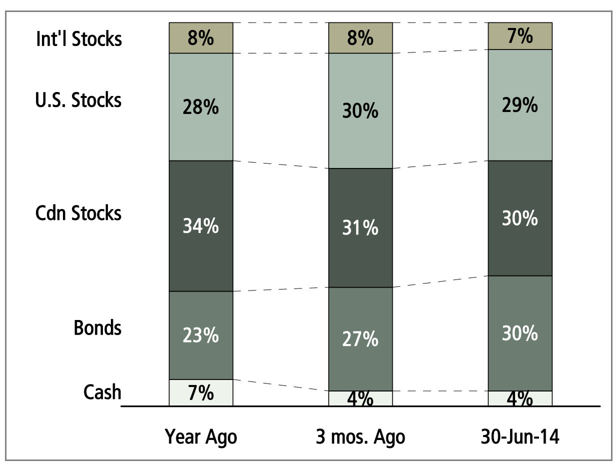
After such a strong advance in equity markets, and with bond yields so low, it is hard not to be somewhat cautious about market prospects for the balance of the year. We know however, that predicting short-term fluctuations is a waste of effort, and that many "market timers" have missed much of the market's five year advance by staying on the sidelines. That said, this quarter, as a result of the continued appreciation of equity prices, we trimmed our equity exposure slightly, rebalancing back closer to our long-term target of 65%. While it is true that it is increasingly hard to find new ideas, given the broad advance in stock prices, we have been particularly busy vetting new ideas and confirming the investment thesis behind each of our current holdings. Of one thing we are sure: from current levels: equities remain the preferred vehicle for building long-term wealth.

Returns for longer periods continue to exceed our benchmark and, most importantly, are attractive on an outright basis. The Fund has returned 17.8% in the last twelve months – trailing the benchmark return of 19.3%. It has bettered the benchmark for 2, 3, and 5 year periods, and has provided an annual average return of 8.4% for the last 10 years, which comfortably exceeds the benchmark return over this period of 6.9%. 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	2.7%	1.7%	4.5%	2.9%	1.4%
Benchmark	*3.6%*	*2.0%*	*6.4%*	*1.6%*	
One Year					
Fund	17.8%	5.8%	26.1%	25.6%	18.7%
Benchmark	*19.3%*	*5.3%*	*28.7%*	*26.6%*	

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, 2014



Balanced Fund Asset Mix

Nexus North American Income Fund

After a strong first quarter to begin 2014, the Nexus North American Income Fund had a satisfactory quarter on an outright basis but underperformed its benchmark. The Fund returned 1.5% while the Bond Index advanced 2.0%. Over the last year, the Fund has managed a heady return of 8.1%, compared to a 5.3% return from the Bond Index over the same period. More detail of the Fund's performance is laid out in the table below.

We remain pleased with the consistency of the returns and the low volatility of the Fund. We intend the Fund to be an excellent alternative to other savings products and a superior alternative to other fixed income strategies. 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 6.7% per annum.

It was more of the same in the bond market this quarter, with falling yields and spreads between corporate and government bonds continuing to contract. Rates are now at their lowest level in the last year and as a result have generated surprisingly good returns so far in 2014. Over the most recent quarter, the Bond Index generated a 2.0% return. The bond component of the Fund returned 1.6%, lagging the 2.0% return of the Bond Index. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

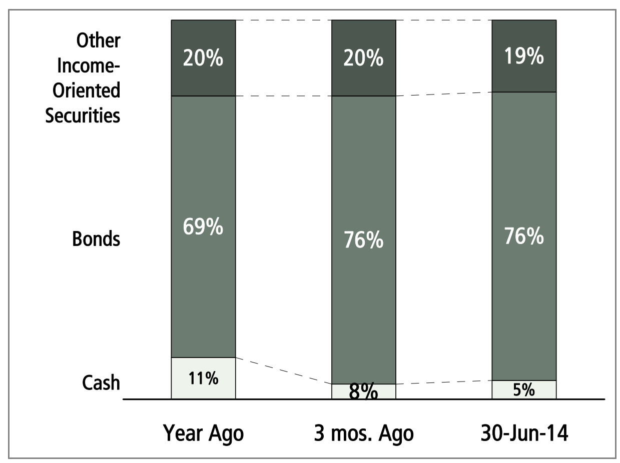
Not only did our bond returns lag the index slightly, but the allocation to "Other Income-Oriented" securities detracted from performance as well. Our Canadian holdings fared well. However, our U.S. returns were negatively affected by a moderate decline in shares of Pfizer and JPMorgan, as well as the strengthening of the Canadian dollar. Given the substantial decline in bond yields, we have moderate expectations for future returns. On the other hand, we continue to expect better returns, albeit with greater volatility, from our allocation to Other Income-Oriented securities.

Looking at asset mix, we remain fully invested in the Other Income-Oriented sector, with an allocation of 19.5%, effectively the same level as last quarter. This is just below the Fund's limit of 20%. Our cash position (4.6%) is fractionally greater than it was at the time of our last report.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	1.5%	1.6%	2.9%	-4.2%
Benchmark	*2.0%*	*2.0%*		
One Year				
Fund	8.1%	5.7%	21.5%	18.0%
Benchmark	*5.3%*	*5.3%*		

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, 2014



Income Fund Asset Mix

Financial Market Summary

Market Levels

	June 30, 2014	December 31, 2013
Canada		
TSX Composite Index	15,146	13,622
91-Day T-Bill Yield	0.94%	0.91%
30-Year Government of Canada Bond Yield	2.78%	3.24%
Prime Rate	3.00%	3.00%
Exchange Rate (US$ per C$)	0.9372	0.9402
United States		
Dow Jones Industrial Average	16,827	16,577
Standard & Poor's 500 Index	1,960	1,848
30-Year U.S. Treasury Yield	3.36%	3.97%

Market Returns for Periods Ended June 30, 2014 [1]

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
FTSE TMX 91-Day T-Bill Index	0.2%	1.0%	0.8%	2.0%
FTSE TMX Universe Bond Index	2.0%	5.3%	5.2%	5.5%
TSX Composite Index	6.4%	28.7%	11.0%	8.8%
S&P 500 Index (in C$)	1.6%	26.6%	16.8%	5.4%
MSCI EAFE Index (in C$)	0.5%	25.5%	9.9%	4.5%
MSCI Emerging Markets Index (in C$)	3.0%	16.1%	7.4%	9.4%

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.