A September to Remember

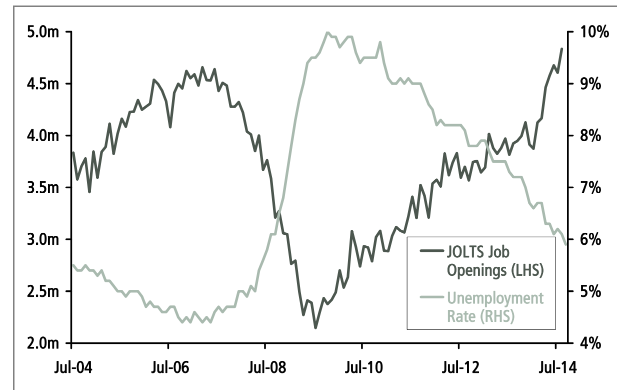
The third quarter of 2014 came in like a lamb and went out like a lion, at least from an investment point of view. Stock markets around the world stumbled in September, and continue to be unsettled in early October. The Canadian market was particularly weak as a sizeable pullback in commodity prices hit the stock prices of many Canadian companies hard. Over the course of the quarter, the price of oil fell from $105.37 per barrel to $91.16.[1] Gold fell from $1,312 per ounce to $1,216.[2] The stocks that led the Canadian market to a stellar first half result are now leading the retreat.

Despite the decline in September, one-year returns are still outstanding in the Canadian stock market and even better in the U.S. Perhaps more important, however, is to underscore how durable the bull market has been in equities over several years. Three-year returns in Canada have been 12.1% per year.[3] The U.S. has soared 26.1% per year and, despite the well-publicized economic struggles in Europe, the EAFE[4] index has returned 16.6% per year over the last three years.

Of course, the key investment question of the day is whether the market's stumble in September is the beginning of a more difficult period for investors after such an extended bull market ascent.

U.S. Economy Gains Momentum

Over the last three months, the U.S. economic recovery continued to gain momentum. Early in October, for example, the Non-Farm Payroll report for September proved to be another pleasant surprise for investors. The report showed that 248,000 new jobs were created in September and the unemployment rate fell to 5.9%, the lowest level since July 2008. The September job gain was not only better than expectations, but brings the 2014 average to 227,000 new jobs per month. If this pace continues through to the end of the year, 2014 will be the best year for new job creation since the late 1990s.



U.S. Labour Market

While the jobs report was good, it is important to note a couple of caveats. Part of the reason for the declining unemployment rate is a further decline in the work force – the denominator in the calculation of unemployment. More specifically, the labour force participation rate – the percentage of the population in the labour force – dropped to 62.7%, the lowest rate since February 1978. As well, average hourly earnings declined in September and are up barely 2% in the last 12 months. Even though job growth has been strong, the average worker's wages barely kept pace with inflation.

Despite these caveats, the jobs data are definitely encouraging for investors. Combined with the ongoing improvements in other measures, such as industrial production and retail sales, our belief that the gradual U.S. recovery is accelerating seems well supported.

A consequence of the U.S. economy's positive momentum has been the remarkable strength in the U.S. dollar. Investors now believe that a normalization of interest rates (i.e., an increase) will happen sooner in the U.S. than was previously assumed. This expectation for higher interest rates, combined with a strong U.S. economy, means that global investors want to hold U.S. dollars. Depending on the basket of currencies one compares it to, the U.S. dollar rose about 8% in the third quarter. Except for a brief period during the financial crisis in 2008 (when the dollar was considered to be the only safe asset in the world) this is the biggest quarterly gain for the dollar since 1992.

While a strong dollar is a clear result of many positive trends in the U.S., it brings with it certain challenges. The weak commodity prices that have particularly undermined natural resource stocks have been one casualty of the strong dollar. As the U.S. dollar has risen, commodity prices have fallen in almost a mirror

[1] West Texas Intermediate spot price (US$/barrel).
[2] Spot gold – London fix (US$/ounce).
[3] Annualized total returns expressed in C$.
[4] Europe, Australasia, and the Far East.

image. In the case of oil, for example, a lower U.S. dollar price per barrel is necessary to offset the higher price of U.S. dollars for buyers in Europe and Asia. Perhaps of greater relevance to U.S. markets, however, is that the strong dollar has resulted in the domestic operations of U.S. companies becoming less competitive, and the overseas earnings of large multinationals are suddenly worth less when converted back into U.S. dollars.

As always, there are many countervailing forces to consider when evaluating the U.S. economy. On balance, however, we believe that conditions are improving and should provide a tailwind for corporate earnings in the period ahead.

Looking Better in Canada

For several quarters we have remarked on the weak performance of the Canadian economy, but expressed optimism that eventually Canada would get dragged along by improving conditions in the U.S. Finally, this seems to have started. Despite a drop in September, exports gained considerable strength over the summer. Industrial production also has climbed. This better performance has been driven by two simple factors. First, the steady decline in the Canadian dollar has made our manufacturers more competitive in the global market place. Second, demand for our products (especially things like auto parts) has increased measurably along with the accelerating economic recovery of our largest trading partner, the United States. So long as our dollar remains low and U.S. demand continues to improve, we expect conditions in Canada to get better.

A Complex World

Outside of North America, the world remains a complex place and presents many challenges for investors. For example, just when we thought the worst was over for Europe, conditions deteriorated again over the last quarter. Both leading economic indicators and measures of consumer confidence turned lower after a period when conditions seemed to have stabilized. Worries also persist about the slowdown of growth in China. While this is true, we observe that China now suffers from the law of large numbers. As the second largest economy in the world it can't possibly grow at the same rate it has in the past. It is also important to note that while the rate of growth has slowed, the absolute growth of its GDP every quarter remains large and steady.

Of course, the world is filled with geo-political risks that change over time, but always seem poised to cause great distress. Earlier in the year we worried about Iran, the Crimea and even another Quebec referendum (before the spectacular implosion of the PQ in the provincial election). Today it is ISIS, Ebola and the stand-off between Russia and Ukraine that grab our attention. Most of the time these risks turn out better than feared, but any one of them could be a catalyst for a disruption to markets.

Holding A Steady Course

Since investors have enjoyed many years of great investment returns, and so much uncertainty in the world persists, many think it is wise to "take money off the table". There were many who thought the same thing three years ago, and missed an incredible rise in stock markets. Long-time clients are well aware that we see any attempt to time the market as a fool's errand. It is certain we will encounter a market correction at some point in the future. However, it is impossible to predict its timing. Valuations in the market are full, but not excessive. As we said last quarter, markets don't correct because they are pricey. They correct because of some unexpected catalyst. The most likely outcome in the period ahead is that economic growth will continue to improve in Canada and the U.S., and this should support better earnings for the companies in which we are invested. It is highly unlikely that returns will be as good in the next year as they have been in the last, but there is a good chance they will be fine.

Many investors harbour strong feelings of angst as they consider the numerous risks before them. As London Business School professor, Elroy Dimson, points out, "Risk means more things can happen than will happen."[5] In our view, the best therapy for these feelings is to focus on a sensible time horizon. By accepting the fact that the immediate future is unknowable, we don't waste a lot of time worrying about it. Instead, we worry about finding companies with good business models, solid balance sheets and attractive growth prospects. The shares of such companies will no doubt decline in a general market correction. But, if we choose high quality companies with reasonable valuations, we are certain to be properly rewarded over time. As Warren Buffett so wisely points out, "Investing is simple, but not easy."

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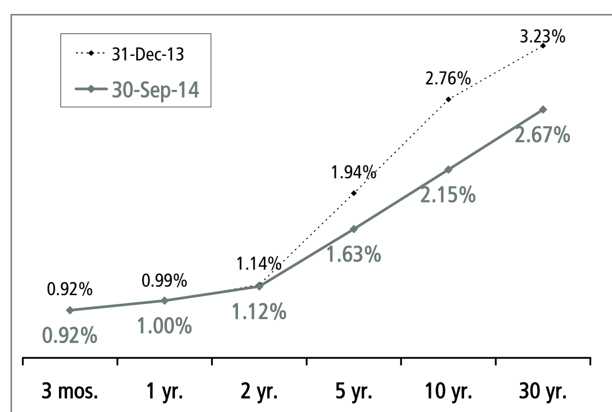
[5] Quoted by Howard Marks, Oaktree Capital Management, Sept. 3, 2014

Asset Class Investment Review

Fixed Income

It was a mixed quarter in bond markets. Rates rose in some areas of the yield curve and fell in others. At the longer end of the market, the trend to lower rates that has been in place so far in 2014 continued for both July and August. Ten-year Canada bonds ended the quarter at a yield of 2.15%, but were as low as 2.00% at the end of August – a steep fall from the 2.75% rate at which they started the year. On the other hand, yields for five-year and shorter bonds actually rose over the quarter: five-year Canada yields increased from 1.53% to 1.63%. As a result, the FTSE TMX Bond Universe Index[6] (the "Bond Index") generated a 1.1% return in the quarter. The returns of our fixed income holdings, using those in the Income Fund as a proxy, returned 0.6%. So far this year our bonds have generated a 4.8% return, which is well ahead of the expectations we held for this asset category at the beginning of the year. Nonetheless, these results trailed the Bond Index, which has returned 5.9% over the same period.



Government of Canada Yield Curve

Our long-term outlook for fixed income markets remains subdued. Rates at today's low levels are an aberration when compared to history and an eventual return to "normal" interest rates will pressure bond prices lower. However, what is unknown is the pace at which it will happen and when it will begin. There is mounting evidence of an acceleration of economic growth in the U.S. This growth will take up the slack that exists in the U.S. economy and eventually begin to create upward pressure on inflation. Minutes of the Meeting of the Board of Governors of the U.S. Federal Reserve released in September showed that the Fed was continuing to wind-down its asset purchase program (bond buying). But it maintained "that it likely will be appropriate to maintain the current target range for the federal funds rate for a considerable time after the asset purchase program ends, especially if projected inflation continues to run below the Committee's 2% longer-run goal".[7] Interpreting the meaning of the phrase "considerable time" now pre-occupies bond managers. To us, absent a dramatic change in the course of the U.S. recovery, we think the Federal Reserve seems likely to begin to raise rates in the second quarter of 2015.

It is different in Canada. As in the U.S., inflation remains well-controlled, but there is scant evidence of a self-sustaining cyclical recovery as there is in the U.S. Our economic improvement, such as it has been, has been based on the U.S. recovery dragging the Canadian economy forward. And unlike the U.S., our central bank continues to convey a clear message that Canada still needs a stimulative monetary policy that will not be tied to the onset of tighter monetary policies in the U.S. In successive speeches in mid-September, Governor Poloz, Senior Deputy Governor Wilkins and Deputy Governor Lane, each laid out the case for a continuing policy of easy money and a future where the neutral rate of interest is much lower than what has been the case historically.[8]

Understanding the intentions of central banks is fundamental to calling the bond market correctly. If it is the desire of the Bank of Canada to run an independent monetary policy from the Fed, then short rates in Canada may stay lower for longer than we have been thinking. However, central banks have much less influence on long term rates than on money market rates. At the long end of the yield curve, an eventual increase in U.S. rates will surely pressure Canadian rates higher. For now, concentrating our holdings in bonds with maturities shorter than 10 years seems the right strategy.

Equities

The third quarter of 2014 jolted investors, many of whom had been lulled by strong and steady equity returns. July and August continued the positive run, but September was a negative month for all the

[6] Formerly the DEX Universe Bond Index.

[7] Federal Reserve Board Press Release – September 17, 2014.

[8] Float of the Loonie – September 16. Monetary Policy and the Underwhelming Recovery – September 22. Are We There Yet? The United States and Canada after the Global Financial Crisis – September 24.

major equity indices around the world. The TSX return in September was -4.0% and the S&P 500 was -1.4%. Only the weaker Canadian dollar skated the S&P 500 measured in Canadian dollars onside in September (up 1.8%). Elsewhere, September was also gloomy, with international developed markets down 0.7% and emerging markets down 4.4%.[9]

Nonetheless, the third quarter as a whole added further to equity returns – and still at a good pace. As an indicator, the Equity Fund was up 3.5% in the quarter.[10]

Canadian Equities

Nexus Canadian stocks were down 0.5% in the third quarter, but up 18.9% over the past twelve months. This was a snick ahead of the TSX Composite (down 0.6%) in the quarter, and slightly behind the TSX's very strong showing of +20.4% over the past twelve months.

When markets turn down, commodity-based companies are typically hit badly. This has certainly been the case this time in Canada. Consistent with this, our Energy sector holdings were the weakest in the portfolio, but we have no holdings in the Materials sector. By contrast, Consumer Staples tend to hold up relatively well and our holdings – Alimentation Couche-Tard and Metro – both had double digits returns in the quarter.

U.S. Equities

For the full quarter, the S&P 500 was up only 1.1% in U.S. dollars. The significant weakening of the Canadian dollar helped Canadian-based investors considerably, with the S&P 500 measured in our currency up a strong 6.2%. Nexus's U.S. holdings worked overtime – and with stellar results, as our U.S. equity portfolio returned 9.4% in the quarter and is up 39.3% for the twelve months, well ahead of the S&P 500's 30.5% return. This is clearly a pace that neither we nor the index can sustain!

Our success during the quarter stemmed partly from a big move in Gilead Sciences. But our Financial holdings (Citigroup and JP Morgan) and several of our Technology holdings (Microsoft, Apple, Hewlett-Packard and Western Digital) had double digit returns in the quarter. Gilead is experiencing continued success with Sovaldi, its new Hepatitis C drug, and its portfolio of AIDS/HIV drugs, so there was not a great deal of new news on that front. Rather, Gilead's share price increased after being constrained earlier in the year by negative press regarding the high price of Sovaldi and as investors started to get a better sense of the size of the market opportunity for Sovaldi.

During the quarter, we sold Covidien. As indicated last quarter, Covidien has received a takeover offer from Medtronic. While there is a sensible rationale for combining the businesses, we were happy with the valuation and concerned about deal risk, as part of the rationale for the deal was 'tax inversion' benefits. Indeed, since then, the U.S. government has introduced new rules to stem tax inversions. At this point, it looks like the Covidien deal will still go ahead.

We added one new position to the U.S. portfolio – General Electric. GE is well known and a very large company. So what is the angle here? There are three reasons we find GE appealing. First, GE is undergoing a meaningful restructuring with the aim of becoming a lower cost, more focused industrial company with a smaller financial services business. Second, GE had already fallen out of favour with investors and the restructuring is further clouding the picture, with the result that GE is trading at a material valuation discount to its peers. Finally, we think that GE offers the key characteristics that Nexus looks for – growth in good times and quality and stability in difficult times.

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 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).[11]

With the recent economic weakness in Europe and emerging markets, along with considerable geo-political concerns, these holdings have held up relatively well. EQIT was flat for the quarter and +11.6% for the last twelve months. EMEC was up 0.1% in the quarter and +12.8% in the last year. Both carry valuation multiples that are attractive compared to North-American equities.

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[9] Except where indicated, all U.S. and international returns are measured in Canadian dollars.

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

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

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund recorded another strong quarter, continuing where it had left off at the end of the second quarter. With more than half the assets denominated in non-Canadian currencies, returns were assisted by a substantial slide in the Canadian dollar. In the quarter, the Equity Fund managed an advance of 3.5%, which led the 2.5% advance of the Fund's benchmark.

There was a divergence of returns between equity markets in the most recent quarter. The TSX declined 0.6%, a return dragged lower by softer commodity prices and a stumbling economic recovery. Our Canadian holdings returned -0.5%. On the other hand, better economic conditions in the U.S., as well as strong operating results for a number of our holdings, generated excellent U.S. returns. The S&P 500 returned 6.2% this quarter and our holdings did even better, returning 9.4%. The EQIT Fund, which invests internationally in developed markets returned 0.0%, and the EMEC Fund, which invests in emerging markets, rose 0.1%. These are clearly difficult times to be an investor in these markets. However, they contain many attractively valued companies with large, growing investment opportunities. We are prepared to put up with a fair degree of short-term volatility in order to capture the long-term opportunity that we think exists. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

Apart from such regular considerations as valuation, economic performance and corporate earnings, equity markets are susceptible to sudden changes in the geo-political environment. This year, we have had a steady succession of concerns; the Ukraine and Russia, Syria and ISIS, Israel and Hamas, and now ebola and growing political unrest in Hong Kong. In our opinion, there is little to be gained by fleeing equity markets, which will surely exhibit extra volatility in light of the unsettled nature of the world. While it continues to be tempting to "take money off the table", we believe that such timing strategies are prone to disappointment. Instead, we will keep allocations close to long-term targets and we maintain, that even from current levels, equities remain the preferred vehicle for building long-term wealth.

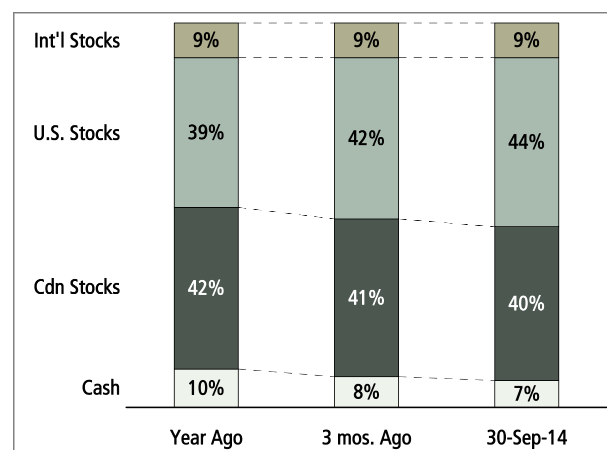
Our cash position is just less than 7%, a slight reduction from last quarter. Our allocation to Canadian stocks at 40% is unchanged and, due to appreciation, U.S. stocks now compose 44% of the portfolio. The balance, almost 9%, is invested outside of North America through our holdings of EQIT and EMEC.

Returns for longer periods continue to be excellent. The Fund has returned 23.5% in the last twelve months, keeping pace with the 23.9% return of our benchmark. More importantly, the Fund has provided an annual average return of 9.1% for the last 10 years, a substantial increment above the 7.7% return from the benchmark. 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	3.5%	-0.5%	9.4%	0.0%
Benchmark	*2.5%*	*-0.6%*	*6.2%*	
One Year				
Fund	23.5%	18.9%	39.3%	17.5%
Benchmark	*23.9%*	*20.4%*	*30.5%*	

Returns are presented before deduction of management fees. Benchmarks are (a) for the Fund: 5% FTSE TMX 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 September 30, 2014



Equity Fund Asset Mix

Nexus North American Balanced Fund

The Nexus North American Balanced Fund advanced 2.7% this quarter, coincidentally the same amount that it advanced in the second quarter. All asset classes provided positive returns. These results led our benchmark, which advanced 1.6% in the third quarter.

Turning first to equities, there was a divergence of returns between equity markets in the quarter. The TSX Composite declined 0.6%, a return dragged lower by softer commodity prices and a stumbling economic recovery. Our Canadian holdings returned -0.2%. On the other hand, better economic conditions in the U.S., as well as strong operating results for a number of our holdings, generated excellent U.S. returns. The S&P 500 returned 6.2% this quarter and our holdings did even better, returning 9.2%. The EQIT Fund, which invests internationally in developed markets returned 0.0%, and the EMEC Fund, which invests in emerging markets, rose 0.1%. These are clearly difficult times to be an investor in these markets. However, they contain many attractively valued companies with large, growing investment opportunities. We are prepared to put up with a fair degree of short-term volatility in order to capture the long-term opportunity that we think exists. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

In the bond market, it was a reasonably uneventful quarter with market activity and volumes perhaps affected by "summer doldrums". As has been the case for some time, international demand and intentionally easy monetary policies, have created very favourable conditions for investors in Canada's bond market. Rates are close to their lowest levels in a year and spreads between corporate and government yields remain tight. As a result, returns have been better than what we would have predicted at the end of 2013. In the most recent quarter, the bond index generated a 1.1% return. The bond component of the Fund returned 0.6%, lagging the bond index return. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

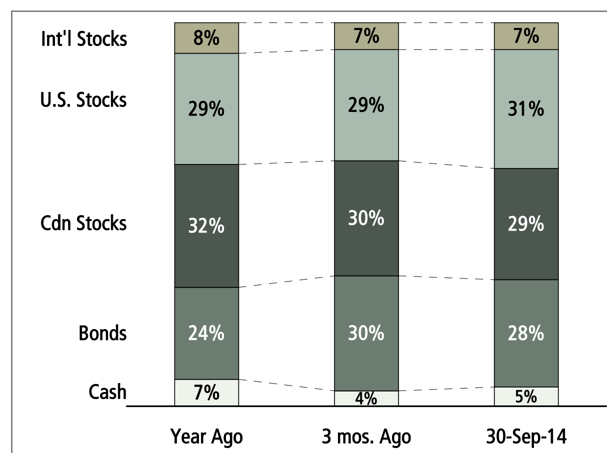
Apart from such regular considerations as valuation, economic performance and corporate earnings, both bond and equity markets are susceptible to sudden changes in the geo-political environment. This year, we have had a steady succession of concerns; the Ukraine and Russian, Syria and ISIS, Israel and Hamas, and now ebola and political unrest in Hong Kong. In our opinion, there is little to be gained by fleeing equity markets, which will surely exhibit extra volatility in light of the unsettled nature of the world. While it continues to be tempting to "take money off the table" we continue to believe that such timing strategies are prone to disappointment. Instead, we will keep allocations close to long-term targets and we maintain, that even 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 18.5% in the last twelve months – exceeding the benchmark return of 17.5%. Our returns for 2, 3, 5 and 10 year periods also are higher than the benchmark and very attractive on an outright basis. 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%	0.6%	-0.2%	9.2%	0.0%
Benchmark	*1.6%*	*1.1%*	*-0.6%*	*6.2%*	
One Year					
Fund	18.5%	5.8%	19.1%	37.9%	18.7%
Benchmark	*17.5%*	*6.3%*	*20.4%*	*30.5%*	

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

Investment Returns – As at September 30, 2014



Balanced Fund Asset Mix

Nexus North American Income Fund

After a strong start to the year, the Nexus North American Income Fund had another satisfactory quarter. But, like the previous quarter, it slightly underperformed its benchmark. The Fund returned 0.9% while the Bond Index advanced 1.1%. Over the last year, the Fund has managed a return of 7.7%, compared to a 6.3% 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 traditional 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 6.4% per annum, while inflation has been only 1.8%.

It was a reasonably uneventful quarter with market activity and volumes perhaps affected by "summer doldrums". As has been the case for some time, international demand and intentionally easy monetary policies, have created very favourable conditions for investors in Canada's bond market. Rates are close to their lowest levels in a year and spreads between corporate and government yields remain tight. As a result, returns have been better than what we would have predicted at the end of 2013. In the most recent quarter, the bond index generated a 1.1% return. The bond component of the Fund returned 0.6%, lagging the bond index return. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

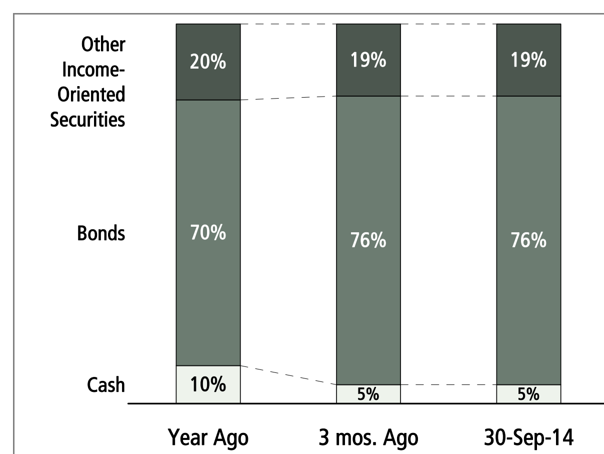
Our allocation to 'Other Income-Oriented' securities contributed positively to returns again this quarter. In late July, we established a new position in Northern Properties REIT (NPR). NPR owns and manages multi-family and commercial rental properties in Canada's far north as well Alberta, Saskatchewan, Newfoundland and B.C. It operates conservatively, using less financial leverage than its peers, and pays out less of its cash flow to unitholders, thus preserving a margin of safety in its business. Because of the locations, the markets it serves are less competitive than more urban markets and government or government employees make up a significant proportion of NPR's tenants. It is unlike our other two holdings in the REIT space and provides good diversification.

Looking at asset mix, we remain fully invested in the 'Other Income-Oriented' sector, with an allocation of 19.4%, effectively the same level as last quarter. We remain just below the Fund's limit of 20%. Our cash position (5.2%) is fractionally greater than it was at the time of our last report.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	0.9%	0.6%	0.6%	10.0%
Benchmark	*1.1%*	*1.1%*		
One Year				
Fund	7.7%	5.7%	15.5%	29.8%
Benchmark	*6.3%*	*6.3%*		

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

Investment Returns – As at September 30, 2014



Income Fund Asset Mix

Financial Market Summary

Market Levels

	September 30, 2014	December 31, 2013
Canada		
TSX Composite Index	14,977	13,622
91-Day T-Bill Yield	0.91%	0.91%
30-Year Government of Canada Bond Yield	2.67%	3.24%
Prime Rate	3.00%	3.00%
Exchange Rate (US$ per C$)	0.8929	0.9402
United States		
Dow Jones Industrial Average	17,071	16,577
Standard & Poor's 500 Index	1,978	1,848
30-Year U.S. Treasury Yield	3.21%	3.97%

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

	Last Quarter	Last 12 Months	Last 5 Years [2]	Last 10 Years [2]
FTSE TMX 91-Day T-Bill Index	0.3%	0.9%	0.9%	2.0%
FTSE TMX Universe Bond Index	1.1%	6.3%	4.9%	5.4%
TSX Composite Index	-0.6%	20.4%	8.7%	8.5%
S&P 500 Index (in C$)	6.2%	30.5%	16.7%	6.8%
MSCI EAFE Index (in C$)	-1.2%	13.6%	7.5%	5.0%
MSCI Emerging Markets Index (in C$)	1.3%	13.7%	5.4%	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.