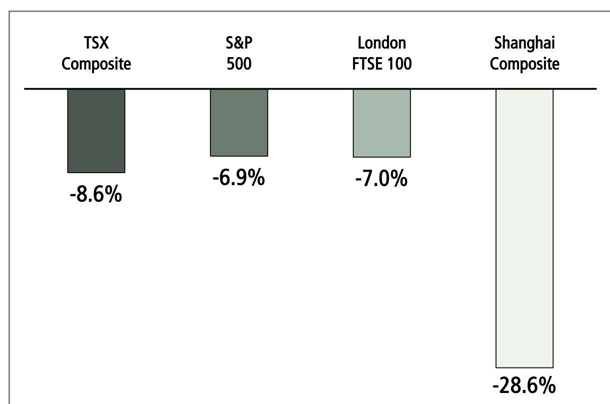
An Unsettling Time

The summer of 2015 was an unsettling time for investors. After a reasonably strong July, stock markets around the world sank in August and September, and volatility spiked. The beach was a much more pleasant place than financial markets.

With a decline of 6.9% in the S&P 500[1], the U.S. stock market was actually one of the best performing markets in the world during the third quarter. Canada, and most markets in Europe, were slightly worse (in local currency terms). Many markets in Asia were substantially worse.

As the U.S. market declined in August, it hit the level deemed a "correction" – a drop of at least 10% from the recent high. Notably, the duration of the recent up-trend in the U.S. market – the time between the last correction and this one – was the third longest in the last 100 years. Investors had become pretty used to constantly rising stock prices. Accordingly, it is not surprising that in conjunction with the correction, volatility also spiked significantly. The VIX Index, the most commonly used measure of market volatility, rose to levels last seen in the summer of 2011, when the debt of the U.S. Government was downgraded from its AAA rating.

Investors were also rattled in the last quarter by dramatic stock market declines abroad. In particular, the Shanghai Composite captured imaginations with its breathtaking 28.6% plunge.[1] While some worried that this might be the harbinger of a devastating bear market, more likely it is simply the reversal of speculative froth from early in the year. The Chinese market is still 29% higher at September 30 than a year ago. Nevertheless, the decline is worrisome.



Returns[1] or 3 Months Ended September 30, 2015

[1] Index price level only, in local currency terms.

The Recession That Wasn't

There is a common rule of thumb that a recession is defined as two consecutive quarters of negative GDP growth. By this definition, Canada was in recession in the first half of this year. In the heat of an election campaign what could be better than to blame the incumbent government for a recession? Without any desire to make a political statement, however, we would point out that the rule of thumb is nothing more than that – a simplification that allows the media and the "man in the street" to understand complicated economic dynamics. The more complete definition of a recession is a broad-based decline in economic activity. On this basis, we think talk of a Canadian recession is overdone.

Perhaps the most compelling example that economic conditions are not as bad as some suggest is the reasonably strong performance of the Canadian labour market. To the end of August, the Canadian economy created a total of 114,500 jobs over the course of 2015. Moreover, the details are even better than the headline. The new job total is the combination of 173,700 full-time jobs created and 59,200 part-time jobs eliminated. If our economy was truly in a downturn, total jobs would be going down, not up, and the mix between full-time and part-time jobs would be getting worse, not better.

Another important observation is that economic weakness is primarily concentrated in energy and other natural resource industries. It is not broad-based. The decline in commodity prices has been a serious drag in certain regions of the country, but it has also translated into a lower Canadian dollar. The weak dollar has been a boon to export-oriented manufacturing industries in central Canada. We are an export-oriented nation and our exports, excluding energy, recently reached their best level since 2007. The benefit of the cheap Canadian dollar is beginning to work its way through the economy.

To be sure, economic growth in Canada is not robust, and many commodity-oriented regions are depressed. But we do believe conditions will slowly improve as manufacturers capitalize on the lower loonie and as the economic recovery in the U.S. continues to expand.

U.S. Recovery Continues

Our belief in an accelerating U.S. economic recovery was tested in early October. The U.S. Bureau of

Labor Statistics released a surprisingly weak non-farm payroll report for September. Against an expectation of approximately 200,000 new jobs created in the month, only 142,000 were created. Job gains previously reported for July and August were revised lower. Average hourly earnings, which had been advancing steadily earlier in the year, were flat in September. The length of the work week actually declined. While the unemployment rate was unchanged at 5.1%, this was only because of a further decline in the participation rate[2] to the lowest level since 1977.

This data has caused many nervous investors to fear that the U.S. recovery might be derailed. We remain considerably more sanguine since a range of other labour market data remains encouraging. Weekly jobless claims continue to run below 300,000, the ADP private sector job survey remains strong, and the non-farm employment report from the household survey is flashing a much more positive signal than the more widely followed payroll report. As well, the JOLTS Index[3], reported to be one of Fed Chairman Janet Yellen's favourite indicators, hit a record high in July.

Also inconsistent with the idea of a deteriorating economy is that a number of statistics tracking consumer behaviour are strong. Consumer sentiment recently surprised to the upside, according to the University of Michigan survey. House prices and housing starts remain robust. Auto sales are running at an 18 million annual rate, the strongest showing in a decade. Of course, low interest rates and low gas prices help with these various measures. But if people were genuinely concerned about the economy and their job prospects they would be unlikely to order a new car.

Despite the occasional bump in the road, or the inevitable ambiguity in the torrent of economic data, we remain confident that the U.S. recovery is broadening and should provide a positive backdrop for the earnings of American companies.

China Blues

One of the main culprits in the turbulence afflicting stock markets this summer was worry about economic conditions in China. In particular, the dramatic decline in the Chinese stock market described above has been taken by some to be an ominous signal.

While we claim no special expertise on China, we would observe that it is an economy in significant transition. It is migrating away from a singular focus on goods production, to an economy more balanced with the delivery of services. Its customers are no longer entirely overseas; demand is growing domestically. Most importantly, China is transitioning from a high growth economy to a moderate growth economy. Official targets are for 7% GDP growth in 2015. That remains an astounding rate of growth for an economy that is now the world's second largest. Income and consumption per capita are rising steadily.

As China's growth rate is moderating, and its economy is transitioning, some measures of industrial production have weakened. Its demand for natural resources is growing less rapidly. Canada feels this acutely. China's economy may well go through a rough patch in the period ahead and this may be a drag on global growth. However, we continue to believe that over the long term it will remain a very positive contributor to the strength of the world economy.

Investment Outlook

Despite the turmoil investors have endured over the last three months, Nexus's client portfolios have enjoyed very solid positive returns over the last year. One must be aware, however, that a good part of the uplift arises from the performance of our non-Canadian stocks in a period in which Canadian dollar declined sharply. In other words, our best asset was foreign currencies. We point this out because it is a tailwind that is unlikely to persist.

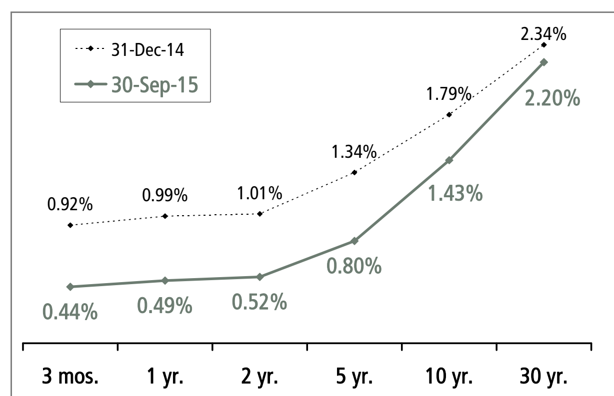
Having said that, we remain optimistic about the outlook for our portfolios. While no one can predict the short term, valuations remain reasonable and we anticipate better corporate earnings growth in the period ahead. Client portfolios are fully invested in equities relative to targets as we continue to believe that they offer the best opportunity for investment success in the long term. However, we also are mindful that volatility could persist and the current correction may be prolonged. While unsettling, turmoil can provide opportunity in the investment world. So long as investors maintain an asset mix appropriate for their circumstances, and remain focused on high quality investments, the long-term outlook is bright.

[2] The number of people working and actively looking for work as a percent of the working age population.
[3] Job Openings and Labor Turnover Survey.

Asset Class Investment Review

Fixed Income

The summer doldrums were alive and well in the bond market in the third quarter. Over that period yields of shorter-maturity government securities were largely unchanged, 5-year bond yields declined from 0.82% to 0.80%, while 10-year bond yields declined modestly from 1.69% to 1.43%. This slight flattening of the yield curve reversed a steepening that occurred in the second quarter. For the year to date, most of the change in the bond market has been in shorter-maturity bonds reacting to the two interest rate cuts from the Bank of Canada (see chart below). In the third quarter the FTSE TMX Canada Bond Universe Index (the Bond Index) returned 0.1%, to be up 2.5% for the year to date. Our return, using the bonds in the Income Fund as a proxy, was slightly better. In the quarter our bond holdings returned 0.2%, and they have returned 3.4% for the year-to-date.



Government of Canada Yield Curve

One noteworthy development this quarter was that yields of both corporate and provincial bonds have continued to widen from Canada bonds. The weaker the credit rating, the more pronounced the drift wider has been. Such weakness, particularly in corporates, is consistent with the weakness in Canadian equities over the same period. But it also reflects a steady supply of new issues at a time when domestic investors' appetites appear to be on the wane. Moreover, selling pressure has also come from international investors wanting to reduce their position in Canada. In the first 7 months of 2015, foreign investors were net sellers of \$8.5 billion of provincial bonds, while in the same period in 2014, they had been net buyers of \$5.6 billion.[4]

Although an emphasis on quality means lower income, we have maintained a strategy of using mostly highly-rated corporates and provincial bonds. As a result of this approach, we have been less affected by this negative spread-widening trend than if we had held positions in higher yielding, but weaker credits.

As for the overall direction of interest rates, in the short run the market has become transfixed on the U.S. Federal Reserve and Chairman Janet Yellen's decision on when to begin to normalize interest rates. The benchmark federal funds rate is currently zero, which is a rate that suggests an economy and capital market in need of emergency support. The Fed has clearly stated that it is prepared to begin this normalization process as the economy accelerates. But, increasingly, external considerations, such as the health of foreign economies and emerging market credit markets, seem to be larger factors in their deliberations. While we acknowledge that there are many downside risks to both the U.S and global economic recoveries, we think that emergency levels of monetary liquidity are no longer required. So, looking into 2016, our outlook for interest rates is that they need to and will go higher. Our portfolio has a short duration (4.3 years) and we retain a bias to higher-rated securities.

Equities

The third quarter of 2015 was decidedly poor for equity investors anywhere in the world. The Canadian equity market was down a whopping 7.9% on a total return basis (including dividends). The S&P 500 lost 6.4% in U.S. dollars (but squeaked out a small gain of 0.5% when measured in Canadian dollars).[5] International and emerging market investors also experienced negative returns.

In light of this, the Equity Fund, although down 1.1% in the quarter, did very well relative to its blended benchmark, which was down 3.7%. The year-to-date total return for the Equity Fund remains positive (at 3.2%) and the twelve month return was a very strong 8.8%, fully 5.1% ahead of the blended benchmark of 3.7%.[6]

---

[4] Statscan as reported in La Presse October 2nd, 2015.

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

[6] All the return data in the Equities section are for the Equity Fund. Equity returns within the Balanced Fund were similar. For

Our investment philosophy is focussed on tight risk controls. As we never know what the market may serve up, we always have a properly diversified portfolio of high-quality, reasonably-priced stocks. Quality is always a good attribute in a portfolio. It doesn't always pay off every quarter, but in markets like these, it pays off in spades. You have likely heard us describe the concept of "down-market capture" – how much a portfolio declines as a percentage of the decline in its benchmark. For the quarter, this figure was only 30%, substantially better than our nearly 16 year record of 69% for the Equity Fund.[7]

The markets have turned down and the period of adjustment is not necessarily over. Although we don't attempt to forecast the economy or the markets, we remain quite sanguine about the general outlook and comfortable with our investments.

Canadian Equities

Nexus's Canadian stocks were down 2.8% in the quarter and down 2.7% over the last twelve months. This was substantially better than the TSX Composite's 7.9% loss for the quarter and 8.4% loss over twelve months.

The poor Canadian return reflects Canada's high exposure to the ongoing travails in the energy and materials sectors, and the knock-on effects on other sectors of the economy.

The major sources of our 'better than market' experience in Canada for the third quarter stem from having no holdings in the materials sector and, although our energy holdings suffered, we experienced relatively less damage in the energy sector than the index did. Finally, our consumer staples and consumer discretionary stocks in Canada did well.

In the quarter we had only one small trade in the Canadian portfolio. Cenovus was carrying an unrealized tax loss and, as we still like the longer-term prospects for this stock, we sold it to capture the tax loss and 'parked' the funds in a similar stock, Canadian Natural Resources. Our intention is to repurchase Cenovus once the 30-day period necessary to capture the tax loss has passed.

U.S. Equities

Nexus's U.S. equities were up slightly in the quarter, returning 1.3%. The twelve month return on our U.S. equity stocks has been strong, up 21.8%, and well ahead of the S&P 500 return of 18.8%. Most of our return, and more than all of the index's return has been due to the weaker Canadian dollar.

In the quarter, several of our quality, value-technology holdings did well. Of particular note, Google announced that it is re-aligning its internal structure into several business units and the market is giving management credit for a greater profitability focus (expense control). As part of this change, the company has been renamed Alphabet.

Other Equity Investments

We continue to hold two non-North American equity investments within our Balanced and Equity Funds. These are two externally-managed pooled funds called EQIT (international developed market equities) and EMEC (international emerging market equities).[8]

EQIT was down 6.8% in the third quarter, poor by any measure, but up nicely over the twelve month period by 7.8%. With all the emerging market concerns over the quarter, EMEC was down 8.3% in the quarter, but down just 0.7% for the twelve months. As we are essentially holding EQIT and EMEC in lieu of Canadian equities, both of these holdings have been an assist to our relative performance over the twelve months and a testament to the benefits of diversification. For more information on EQIT and EMEC, please see the Nexus International Equity Fund section of this report.

---

more specific performance, please refer to the Fund reports in this document or your client-specific report.

[7] We have kept track of up- and down-market capture since January 2000, which is the period since the current portfolio management team has worked together.

[8] Both funds are managed by teams from JPMorgan Asset Management based in London, England.

Pooled Fund Reports

Nexus North American Equity Fund

The Nexus North American Equity Fund had another relatively good quarter, but declined 1.3% on an outright basis. This result was considerably better than our benchmark, which declined 3.7% for the same period. Thankfully returns for longer periods remain excellent. The Fund returned 8.8% in the last 12 months, nicely ahead of the 3.7% return of our benchmark. More importantly, the Fund continues to provide attractive relative and nominal returns for longer holding periods. Over the last ten years, the Fund has generated an annual average return of 7.5%, well above the 6.5% return from the benchmark. More detail of the Fund's performance is set out in the table below.

Equity markets in North America and around the globe were particularly weak again this quarter. The TSX fell 7.9%, but our holdings fared much better, declining 4.0% over the same period. Much of the outperformance comes from the lack of direct commodity exposure in the materials sector, and a low allocation to energy stocks. Our U.S. investments actually provided positive returns, but this owed mostly to the foreign exchange gain that arose from the depreciation of the loonie.

Lower share prices generally create cheaper valuations, which are a necessary precondition for good long-term investment results. With the decline in equity markets that has already occurred on both sides of the border, we are finding more attractive opportunities for the portfolio than at any time in the last year. For now, there have been no notable additions or changes to our holdings to report. But it is likely that we will be a little busier next quarter than has been the case so far in 2015. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

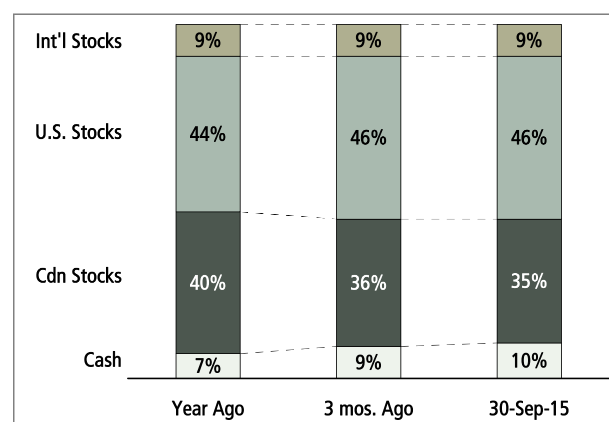
In the current environment, an emphasis on quality and long-term growth potential remains paramount. Our cash position is 10%, marginally more than it was at the end of the prior quarter and above our notional target of 5%. While we have been in no hurry to get capital deployed recently, as noted above, we are expecting to make some new investments in the coming months, as well as add to positions that we own already but which are now cheaper.

Our allocation to Canadian stocks is 35%, about where it was when we last reported, and our U.S. allocation is 46%. The balance of 9% is invested outside of North America through our holdings of EQIT and EMEC.

	Equity Fund	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter				
Fund	-1.1%	-2.8%	1.3%	-7.6%
Benchmark	*-3.7%*	*-7.9%*	*0.5%*	
One Year				
Fund	8.8%	-2.7%	21.8%	3.7%
Benchmark	*3.7%*	*-8.4%*	*18.8%*	

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, 2015



Equity Fund Asset Mix

Nexus North American Balanced Fund

North American investment conditions continued to be difficult in 2015. Weak equity markets and modest bond returns have created challenging conditions for investment managers. After modest losses in the second quarter, the Nexus North American Balanced Fund had another soft quarter, declining 0.5%. However, this result was much better than our benchmark which declined 3.0% for the same period. The Fund has returned 8.0% in the last 12 months, still nicely ahead of the 2.6% return of its benchmark. More importantly, the Fund continues to provide attractive relative and nominal returns for longer holding periods. More detail on the Fund's performance is laid out in the table below.

In the bond market, we continue to emphasize a portfolio of shorter-dated, higher-quality bonds. Government interest rates declined modestly this quarter and our positioning in shorter maturities meant that we were less exposed to the lift in prices than our benchmark, the Bond Index. However, our emphasis on higher-rated credits meant that we were less affected by the widening of spreads in the corporate bond market and the downward effect it had on prices. As such, our returns for this portion of the Fund were 0.2%, hardly inspiring on an outright basis, but ahead of the Bond Index gain of 0.1%. Last quarter we reduced our exposure to Alberta bonds and this quarter we lightened up on a range of corporate credits and substituted Canada Housing Trust bonds as well as better-rated provincial bonds. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

Equity markets were particularly weak again this quarter. The TSX fell 7.9% but our holdings fared much better, declining 2.3% over the same period. Much of the better comparative return comes from the lack of direct commodity exposure in the materials sector, and a low allocation to energy stocks. Our U.S. investments actually provided positive returns, but this owed mostly to the foreign exchange gain that arose from the depreciation of the loonie.

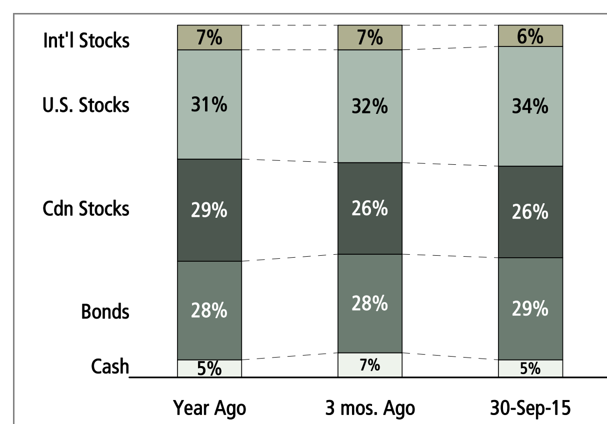
Lower share prices generally create cheaper valuations, which are a necessary precondition for good long-term investment results. With the decline in equity markets that has already occurred on both sides of the border, we are finding more attractive opportunities for the portfolio than at any time in the last year. For now, there have been no notable additions or changes to our holdings to report. But it is likely that we will be a little busier next quarter than has been the case so far in 2015. A more detailed explanation of developments in equity markets appears earlier in the Asset Class Review section of this report.

Our asset allocation is substantially unchanged from last quarter. The cash position is 5%, down from 7%, and the difference has been added to our weighting in bonds, now 29%. The balance, 66%, is in stocks. Within equities, our holdings remain more heavily weighted outside of Canada.

	Balanced Fund	Bonds	Cdn Stocks	U.S. Stocks	Int'l Stocks
Quarter					
Fund	-0.5%	0.2%	-2.3%	1.8%	-7.3%
Benchmark	*-3.0%*	*0.1%*	*-7.9%*	*0.5%*	
One Year					
Fund	8.0%	5.4%	-2.4%	21.7%	4.7%
Benchmark	*2.6%*	*5.3%*	*-8.4%*	*18.8%*	

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, 2015



Balanced Fund Asset Mix

Nexus North American Income Fund

Despite volatile equity markets, a Greek referendum and election, a swelling migrant crisis and more than a 6% depreciation in the Canadian dollar, there was little change to the general level of interest rates last quarter. Longer-dated bonds recovered in price from their weakness in the second quarter, but there was little to no change in the yields of shorter maturity bonds. The Nexus North American Income Fund declined 0.1% this quarter, but has returned 2.7% in the year-to-date. The Fund has kept pace with the performance of its benchmark, the Bond Index, which increased 0.1% over the quarter and is up 2.5% for the year-to-date. More detail on the Fund's performance is set out in the table below.

We continue to emphasize a portfolio of shorter-dated, higher-quality bonds. Our bond maturities remain concentrated between two and seven years. With a portfolio duration of 4.3 years, we have substantially less interest rate exposure than does the Bond Index, which has a duration of 7.4 years. For now, bond investors are narrowly focused on the decisions of the U.S. Federal Reserve and the prospect of a move away from a fed funds rate of zero percent. Such a move remains a core part of our interest rate forecast, but it is likely that the earliest this will occur is in December. Absent an acceleration of economic activity in the rest of the world, the Fed could well extend this period of artificially low rates into 2016. A more detailed explanation of developments in bond markets appears earlier in the Asset Class Review section of this report.

This quarter, we continued to rotate our holdings away from corporate bonds and into bonds issued by top-rated provinces and the Canada Housing Trust. This strategy is meant to address a concern we have with the level of liquidity in the bond market, particularly corporates, and a sense that the investor base has become fatigued with a steady flow of new issuance. Should we end up with the uncertainty of a minority government after the election, international investors might choose to de-emphasize Canadian holdings in their portfolio. Such a change, from buyers to sellers, will put downward pressure on bond prices and raise interest rates in Canada.

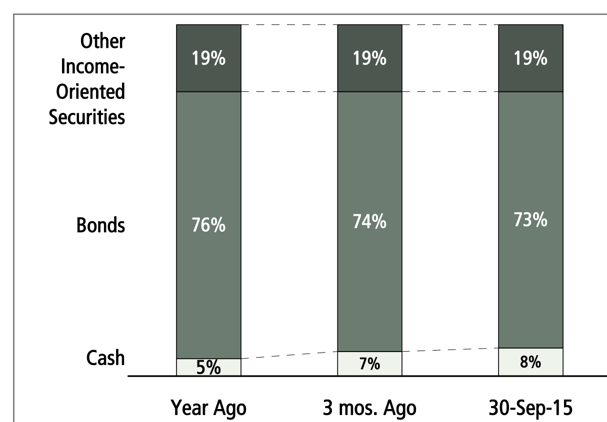
Looking at the "Other Income-Oriented Securities' portion of the portfolio, the sell-off in equity markets has affected the valuation of many of our equity holdings. For instance, at current prices, our REIT investments have distribution yields of more than 6% on average, and our Canadian bank holdings yield more than 4%. Absent a scenario of total economic disaster, it is hard to think that these won't prove a superior way to build capital over the long term than in the bond market.

This quarter, we have let cash build up to 7.5%, the 'Other Income-Oriented Securities' accounts for 19% and the balance, 73.5% is in our core bond holdings.

	Income Fund	Bonds	Cdn Stocks	U.S. Stocks
Quarter				
Fund	-0.1%	0.2%	-3.0%	3.3%
Benchmark	*0.1%*	*0.1%*		
One Year				
Fund	5.4%	5.4%	1.4%	24.4%
Benchmark	*5.3%*	*5.3%*		

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: FTSE TMX Universe Bond; (b) for Bonds: FTSE TMX Universe Bond. In addition to bonds, up to 20% of the Fund's portfolio may be invested in equities.

Investment Returns – As at September 30, 2015

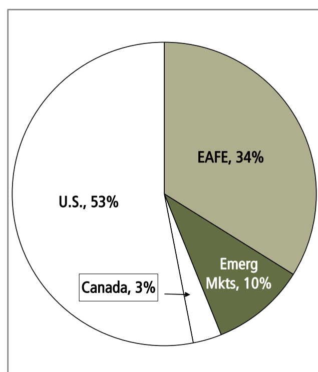


Income Fund Asset Mix

Nexus International Equity Fund

We are excited to have launched the new Nexus International Equity Fund, a pooled fund invested outside North America in international developed markets and emerging markets. "International developed markets" refers to all developed markets outside of North America and is typically referred to as EAFE (Europe, Australasia and the Far East). "Emerging markets" include 23 developing countries, such as India, China, South Africa, Brazil, Taiwan, and South Korea.

We have long believed that exposure to these markets makes good investment sense. To that end, we have held two externally-managed pooled funds in our Balanced and Equity Funds for many years: EQIT (international developed market equities; held since 2002) and EMEC (international emerging market equities; held since 2012). This will continue.



MSCI All World Index (September 30, 2015)

The Nexus International Equity Fund adds new flexibility, as we can now offer a combination of these two underlying pooled funds at a smaller minimum investment than was possible before, and at a lower cost for clients who hold more than $500,000 of combined exposure. There will be no additional expenses from the new fund structure as Nexus will be absorbing the up-front and direct annual costs.

The investment case for the new Fund is compelling:

- EAFE and emerging markets together make up almost half of the global equity investment universe (see exhibit).
- EAFE companies include many familiar global multinationals, such as Nestle and Royal Dutch Shell. Many emerging markets companies, such as Taiwan Semiconductor and China Mobile, are well-established, branded suppliers to very large domestic and international markets alike.
- Despite the issues some emerging market countries face, collectively thse countries offer materially higher long-term growth due to demographics, urbanization, high productivity potential, and low costs.
- These investments complement Nexus's North American equity exposure and offer additional diversification. For example, EAFE has provided stronger returns than the TSX in recent years.
- Both EAFE and EM equities currently carry noticeably lower valuation multiples and higher dividend yields than North American equities.
- The combination of EQIT and EMEC (currently split 64% / 36%) offers more growth than just EQIT alone and less volatility than EMEC alone.
- JPMorgan Asset Management, the manager of EQIT and EMEC, is a proven investment manager with local research specialists in the various countries and a long-established central portfolio management team in London England. EQIT is managed with a larger cap growth bias and EMEC with a larger cap quality bias.

EQIT was down 6.8% in the third quarter, poor by any measure, but up nicely over the 12-month period by 7.8%. With all the emerging market concerns over the quarter, EMEC was down 8.3% in the quarter, but down just 0.7% for the 12 months. Over the past three years, EQIT is up 15.4% per year and EMEC up 5.8% per year – both ahead of the TSX Composite for the same period.

	International Equity Fund	EQIT	EMEC
Quarter			
Fund	n.a.	-6.8%	-8.3%
Benchmark	*n.a.*	*-3.6%*	*-11.8%*
One Year			
Fund	n.a.	7.8%	-0.7%
Benchmark	*n.a.*	*9.2%*	*-3.5%*

Returns are presented before deduction of management fees. Benchmarks are (a) for Fund: 75% MSCI EAFE (in C$) and 25% MSCI Emerging Mkts (in C$) (rebalanced monthly); (b) for EQIT: MSCI EAFE (in C$); and (c) for EMEC: MSCI Emerging Mkts (in C$).

Investment Returns – As at September 30, 2015