Liberty International Investment Management
111 Peter Street, Suite 621 Toronto, ON M5V 2H1
o: 416-304-9510 f: 416-304-9900
toll-free: 1-844-304-9510
www.libertyiim.com

Market Update – 2nd Quarter 2016

This Market Update will encompass the following discussion points:

1) 1st Quarter Market Performance for stocks, bonds, preferred shares and currencies
2) Dividends
3) Why free cash flow helps investors choose the right stocks
4) Answers to client questions

1. 1st Quarter Market Performance – January 1st to March 31st, 2016

Equity Markets

2016 Q1 Returns		
Country	**Stock Indexes**	**Total Return (with dividends re-invested in native currency)**
Canada	S&P TSX	+4.5%
United States	S&P 500	+1.3%
Europe	Stoxx 600	-6.9%
Mexico	Mexbol	+6.9%
Brazil	Ibovespa	+15.4%
Japan	Nikkei	-11.2%
Australia	S&P/ASX 200	-2.7%
China	Shanghai Composite	-15.1%
India	S&P BSE Sensex 30	-2.6%

Data Courtesy of Bloomberg LLP

Equities in the first quarter were led higher in some countries by:

1) A belief that central banks worldwide could pull a rabbit out of a hat any time they wanted to restore confidence.
2) A recovery in the price of oil with the belief that the inventory glut would be temporary and that commodities in general are oversold.

Both conditions imply a lot of faith. With the former, this type of monetary policy has never been followed before. Can the world and its ageing population handle negative interest rates and the accompanying deflationary effects?

With the latter, credit conditions will provide the ultimate direction of commodity prices. For oil and gas companies, they need to continue to pump to provide revenues to pay off debts and other expenses. For countries, they need to pump to provide revenues for social programs.

In the United States, there have been over 250,000 job losses in the oil and gas sector as companies have tried to slash costs to balance their books. Since 2009, US banks were happy to lend to the oil producers to drill more wells. The problem was that the extraction costs exceeded the amount of the loans so the demand to borrow was increased exponentially until the oil price fell from its peak.

The first three months of equity markets in 2016 were also characterized by a tug-of-war exercise between buyers and sellers.

While individual investors pulled money out of mutual funds and index funds, pushing prices down in the first weeks of January, it was later offset by corporations buying back shares and short-covering by hedge funds. This began the rally in mid-February that continues today.

On a valuation basis, these markets are not cheap.

P/E Multiples			
Index	**Country**	**P/E Ratio After OS Items**	**P/E Ratio Before OS Items**
S&P TSX	Canada	21.34	57.63
S&P 500	United States	18.83	23.73
Euro Stoxx 600	Europe	15.19	24.04
MSCI World Index	Global	19.71	22.98

Data courtesy of Bloomberg LLP

In fact, the Price/Earnings multiples have risen from 2015. This has been caused by an increase in stock prices (the numerator) and a decrease in earnings (the denominator).

This is why I still wish to hold cash and only allocate it as opportunities arise.

For the Liberty stock portfolios, each outperformed their underlying benchmarks.

Individually, the big gainers in the quarter were:

- CCL Industries (in TFSAs): up 30%
- Saputo Inc. (in TFSAs): up 26%
- DH Corp (in TFSAs): up 22%
- C.H. Robinson Corp (in global portfolios): up 20%
- Jardine Matheson (in global portfolios): up 17%

Those down the most were:

- Luxottica Group (in global portfolios): down 20%
- AmerisourceBergen (in global portfolios): down 17%
- Novo Nordisk NV (in global portfolios): down 11%
- Novozymes (in global portfolios): down 11%
- Coloplast (in global portfolios): down 11%

In almost all cases, the above price movements were a reversal from last year as the gainers were down in 2015 while the losers were up.

For investors, it suggests that if the price drop is caused by macro-economic events and not by business fundamentals, buying more shares after sell-offs usually results in higher long-term capital gains.

Currency Markets

Canadian Dollar vs.			
	December 31, 2015	**March 31, 2016**	**Gain/Loss%**
British Pound	$2.0430	$1.8675	+8.5%
US Dollar	$1.3855	$1.3004	+6.1%
Euro	$1.5041	$1.4798	+1.6%
Australian Dollar	$1.0117	$0.9958	+1.5%
Danish Krone	$0.2016	$0.1986	+1.5%
Japanese Yen	$0.0115	$0.0115	+0.0%
Mexican Peso	$0.0803	$0.0753	+6.2%
New Zealand Dollar	$0.9536	$0.8985	+5.7%
Norwegian Krone	$0.1563	$0.1573	-0.6%
South African Rand	$0.1005	$0.0881	+12.3%
Swedish Krona	$0.1638	$0.1602	+2.1%
Swiss Franc	$1.3835	$1.3522	+2.2%

Data Courtesy of Bloomberg LLP

The chart above is determined as follows: On December 31, 2015, one British Pound bought $2.043 Canadian dollars. By March 31, 2016, it bought only $1.8675, meaning the Canadian dollar strengthened by 8.5% against the Pound.

Because of a rise in oil prices, the Canadian dollar was up an average 5% for the quarter. If the Loonie hadn't moved, client returns would have been net positive instead of slightly negative. This currency move doesn't bother me in the least.

That's because, over a 20-year period, currency risk is benign. In fact, it took 40 years for the Canadian dollar versus the US dollar to drop from one dollar to 65 cents and back to par.

With the cash we still have on hand, I can use the stronger Canadian dollar to buy more of the foreign currencies.

It's always best to be pragmatic and try to take advantage of opportunities than to play the "Hindsight is 20/20" game, whereby investors try to micro-manage the currency positions, usually to disastrous results.

The important thing before buying anything is to first make a plan and create the right portfolio structure. Everything else should then fall into place.

Bond Markets

10-year Bond Yields		
Country	**Standard & Poors Credit Rating**	**Current Yield**
Greece	CCC	8.34%
Brazil	BB	5.38%
Mexico	BBB (High)	3.46%
New Zealand	AA	2.92%
Australia	AAA	2.52%
United States	AA (High)	1.77%

United Kingdom	AAA	1.41%
Spain	BBB (High)	1.43%
Canada	AAA	1.23%
Japan	A (High)	-0.08%

Data Courtesy of Bloomberg LLP

In the quarter, bond yields continued to fall, forcing many investors to increase their equity weightings because of the lack of real returns offered in the market. Real returns are determined as the yield after tax and inflation.

Despite a credit downgrade for Brazil, the 7.27% yield at the end of 2015 dropped to 5.38%, causing bond prices to rise. Investors perceived the potential impeachment of the president of Brazil, Dilma Rousseff, as positive news.

Meantime, Japan's 10-year yield slipped into negative territory, meaning investors are essentially paying the government to hold their cash. The alternative of owning stocks would have been worse, as the Japanese Nikkei Index fell 11% in Q1.

Preferred Shares

2016 Q1 Returns	
	Gain/Loss%
Canadian Perpetual Preferred Shares	-0.60%
Canadian Variable Rate Reset Preferred Shares	-10.23%
US Perpetual Preferred Shares	+0.44%

With the drop in interest rates in the first quarter, we decided not to buy any of the rate reset preferred shares. In aggregate, they fell 10%. Again, it was better to make 0.50% in cash than lose 10% in these instruments.

Instead, our purchases were directed toward the long-end of the bond market in either the real return bonds (also known as inflation protected bonds) or long-dated corporate bonds such as the Telus Corp. bond that matures in 2043.

As a rule, I want to have at least 5% of the fixed income holdings invested in real return bonds. If deflation persists, they should continue to do well as the prices should rise because they're long-dated and more price sensitive to drops in interest rates.

Additionally, they offer inflation protection, so if we ever get into a period of stagflation (a stagnant economy with inflation), investors will be protected by earning the coupon plus the inflation rate. This means their spending power would stay ahead of inflation.

2. Dividends

This is the time of year when companies announce their dividend increases. Historically, the average dividend growth rate has ranged between 6% and 8% for most developed stock indexes.

For the TFSA accounts which contain a diversified portfolio of 20 Canadian stocks, the average dividend increase so far in 2016 has been only 7%. For the global portfolios, the dividend increase has averaged 9%.

While above the average, it's a huge decline from the double-digit dividend growth we've enjoyed since 2009.

This is another reason why the equity exposure for client portfolios has been only 20% for Canada. Despite a jump in the Canadian dollar, corporate profitability in Canada continues to trail that of the rest of the world.

That's why Canadian investors can't be country-biased. As dividends grow, so should the stock price. If the dividends are growing less, price performance should be lower. This is what we've seen historically from the Canadian market as it has underperformed in 35 of the last 45 years.

3. Fun with Math - Why we start our research with Free Cash Flow

In your life, free cash flow is what's left over after all the bills are paid. The residue (free cash flow) can be saved, spent or invested.

It's the same for a corporation. If they have excess free cash flow, they can:

- Buy back shares
- Raise the dividend
- Pay down debt
- Upgrade their plant and equipment to stay modern and continue to innovate
- Poach valuable employees from their struggling competitors
- Make strategic acquisitions

Using a quick and easy approach free cash flow is calculated as:

Cash flow from operations (CFO)
Less: Capital expenditures (CE)
Less: Cash dividends paid (DV)
Equals: Free Cash Flow (FCF)

Once we screen our 5,000 global universe for consistent free cash flow stocks, the list drops to under 200. From there, we can look at some of the trends in all four segments above.

As an example, let's look at two global consumer product companies, Unilever (which Liberty clients own) and Procter & Gamble.

Here are some of the products they sell:

Unilever	***Procter & Gamble***
Ben & Jerry's ice cream	Tide detergent
Hellmann's mayonnaise	Pampers diapers
Dove & Axe soaps and deodorants	Crest toothpaste
Lipton tea	Duracell batteries
Vaseline	Gillette razors and blades

All great products, which is why both have companies have the following similarities:

- The dividend yields are 3.2%
- The Price/Earnings multiples are 21 times.
- The operating margins are 14%

When we consider free cash flow, however, the differences between the two firms appear. Here are the average 5-year changes:

Unilever	***Procter & Gamble***
Cash flow from operations ***grew*** 7%	Cash flow from operations ***fell*** 2%
Capital expenditures grew 3%	Capital expenditures grew 4%
Dividends grew 9%	Dividends grew 8%

As a result:

Free cash flow ***grew*** 9%	Free cash flow ***fell*** 10%

Add in some other crucial financial metrics and the case for Unilever as a long-term investment strengthens:

Creating a high Return on Invested Capital (ROIC) is the Chief Financial Officer's main job. Simply put, for every dollar of capital invested (both debt and equity), how much is returned in profit?

In this case, Unilever's return on capital, in percentage terms, has historically been in the mid-teens. Last year, it was 20%, thanks to a focus on higher-margin brands such as personal care and ice cream.

For every dollar invested, Unilever made 20 cents of profit. Meantime, Procter & Gamble's return on capital was only 9%, leaving Unilever with a greater level of free cash flow to use strategically.

Because investing in stocks is not about the past, the expected earnings and cash flow growth predict continued good times for Unilever. It expects its earnings to rise by 16% and its cash flow to rise by 12% over the next 5 years, while Procter & Gamble's expected growth rates are 9% for earnings and 10% for cash flow.

The higher numbers are the result of greater sales by Unilever to emerging markets. For example, revenues in Asia are 42% of Unilever's overall sales but only 24% for Procter & Gamble. This region offers a younger consumer with rising spending power.

More importantly for investors, how does this information translate into share performance? In the past 10 years, Unilever's share price has grown by a compounded 10.4% versus 6.0% for Procter & Gamble.

10-year Compound Performance (2005-15)	
	% Return in US Dollars
Unilever (UN US)	10.38%
Procter & Gamble (PG US)	6.03%

Data Courtesy of Bloomberg LLP

This is why we use free cash flow as our stock research starting point. If a company consistently produces free cash flow, it has the financial flexibility to grow its business.

It can spend 100% of its time selling its products and services without having to waste half its time dealing with its bankers, worrying about whether or not it may break any debt covenants (as Valeant Pharmaceuticals faces today).

4. You Wanted to Know

Finally, here are two recent questions from Liberty clients that I wanted to share with you.

1) Who votes my shares?

Liberty does all the proxy voting for shares held by clients. Some of the things we consider when voting:

- We don't want the CEO on the board of directors. The board should be independent of any company influence.
- We don't want directors on the board to sit on other company boards. This reeks of cronyism. For those who believed that "the old boy's network" didn't exist, guess again. Some of the same names keep popping up as directors of different companies. It's as if they're making a career of sitting on multiple boards.
- We are not in favour of most executive compensation plans. We believe there is no justification for inflating both stock and cash compensation, especially when a company has not performed well.
- We want companies to be more transparent. That includes an explanation of their environmental policies, hiring practices and their ability to meet the goals set in these areas.
- We don't want stock options to represent more than 5% of the outstanding shares. We believe anything beyond that is a misrepresentation of shareholder funds as only the executives are being compensated, nobody else.

2) Why can't I look at my portfolio on the Liberty website?

We use Google Analytics to monitor who's looking at the Liberty website. The last time I was on BNN's Market Call program, we had over 200 hits to the website, of which more than 10 were from Russia.

We believe that these are probably "phishing bots" that are trying to hack into the website looking for personal information to be used in identity theft scams.

We also don't provide any links to other websites on the Liberty home page. It's often through links that these bots can infiltrate a client's e-mail account. The net result is that a request for funds may come from a suspicious e-mail account tied to a client's account number. If we believe it's suspicious, we'll contact the client to confirm the money request.

That's why we have National Bank as the home for your on-line portfolios. As a large bank, they have better firewalls than we could ever construct, ensuring that your personal information is as secure as possible.