VALUE CONTRARIAN
ASSET MANAGEMENT

2016 Third Quarter
Value Contrarian Equity Fund

Dear Partners,

> **Low interest rates boost the current value of any income-producing asset. Stock's historically high price-to-earnings ratios can be justified if rates stay low… But the arithmetic reality is that when valuations are so high… it takes only a small shift in the <u>appetite for risk</u>, <u>expectations of profits</u>, <u>or interest rates</u> to trigger a major downdraft (selloff).**
>
> **Greg IP**
> **Wall ST Journal**
> **July 28, 2016**

> **When leverage is loose, asset prices go up because buyers can get easy credit and spend more… [The problem does not start with]... home owners who take on loans that they could not really afford, but rather with lenders … <u>who failed to ask for enough collateral.</u>**
>
> **John Geanakoplos**
> **Yale University**
> **Professor**

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This latest economic cycle differs from its predecessors in important ways. While the economy since 2009 has shown only anemic growth, asset prices (stock, long-dated bonds, real-estate) have experienced a more spectacular recovery than the overall economy. The effects of ultra low interest rates has been a significant factor contributing to these high asset prices.

Nonetheless, it is important to realize that high asset prices can stay that way for many years. But it is also a sign of an economy structurally more vulnerable to sudden shifts (profit warnings, higher interest rates, etc…)

High asset prices also makes your manager more cautious and wary when investing Fund assets. Today's inflated asset prices make it more dangerous to return (raise) interest rates to more normal levels.

Gotta like those Canadian bank stocks … eh?

Perhaps Canadian investors (and our client base) are a bit too smug regarding the invincibility or predictability of Canadian bank stocks. The Canadian government, responding to widespread concerns about the country's inflated housing market, has recently introduced additional sweeping policy changes. These changes will stiffen-up the way banks grant mortgages and assess the risks associated with them.

In our opinion, the second shoe, which could have a greater effect on bank profits, is about to drop in the new year. Specifically, Ottawa will soon take a closer look at what is known as "lender risk-sharing" – which is the idea that banks could

have to pay a deductible and thus require them to share in any losses on government-backed mortgage insurance.

This is a potential new policy option that would require bank lenders to absorb a portion of loan losses on insured mortgages that default, rather than the present situation of transferring virtually all the risk onto the tax payer via government guarantee for mortgage insurers.

Such changes (it's coming), would force Canadian banks to hold additional capital against mortgages. This would raise their funding costs and reduce their ROE (return on equity). Banks with lower ROE's trade at lower P/E ratios. Obviously, the banks will try to pass these new costs onto consumers, in the form of higher mortgage rates.

Bottom line: higher mortgage rates and tougher qualification criteria will translate into a slowing of the Canadian housing market. This sharing of mortgage losses, in a deep recession, will likely affect bank profitability, while also reducing their juicy returns on equity.

Yes, changes are in store for the cozy Canadian banking oligopoly.

Third Quarter Performance

Your Fund ended the September third quarter with a net asset value of $3,369.38 per unit, an increase of $211.77 from the December 31, 2015 net asset value of $3,157.61 (after distributions). This represents a year to date return: +6.71%. Unlike last year, the rising Canadian dollar has negatively affected the fifty percent of our portfolio held in U.S. dollars. The Canadian dollar started the year at 0.72 cents

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and finished the third quarter at 0.76 cents. In addition, our 14% cash position was a drag on performance, particularly as commodity and material/ gold stocks have roared ahead this year.

Clients have recently inquired how we could prepare our portfolio should there be a precipitous stock market fall - post U.S. elections. I gather many investors are worried about a surprise Trump win. As we have always counseled, timing the market is not a credible long-term investment strategy. However, in any portfolio, having some dry gun powder (cash) available, is always a good idea. Especially in case of a surprise "Brexit" style correction.

A real risk to the stock market is when long-term interest rates start to rise more than one percent. When that occurs, asset prices will be in for a readjustment.

The Governor of the Bank of Canada has recently telegraphed that there will likely be no imminent rise in interest rates. The Canadian stock market remains one of the worlds best performing in 2016 (+15.8%). There is still more room to rise in this bull market over the next year.

Predictions: Trump win – market falls 10%-15%
Hillary win – market advances 3% - 5%

Respectfully yours,

Benjamin D. Horwood
Portfolio Manager
November 4, 2016

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P.S. Do visit us at our **NEW** web site: **www.valuecontrarian.com**

**We're often asked: "When is the best time to invest in the Value Contrarian Fund?" Although there is no best time, since it is impossible to time the market, a preferable entry point is when the Fund has produced a month of negative returns or a year of underperformance. Unfortunately, human nature prefers the exact opposite.

Overall, long-term shareholders in the V/C Fund benefit from a sinking stock market, the same as a regular grocery shopper benefits from declining food prices. So when stock markets plummet – as they will from time to time – "neither panic nor mourn". It's good buying news for your Fund.

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