



Newsletter Q1 2015

Dear Investor,

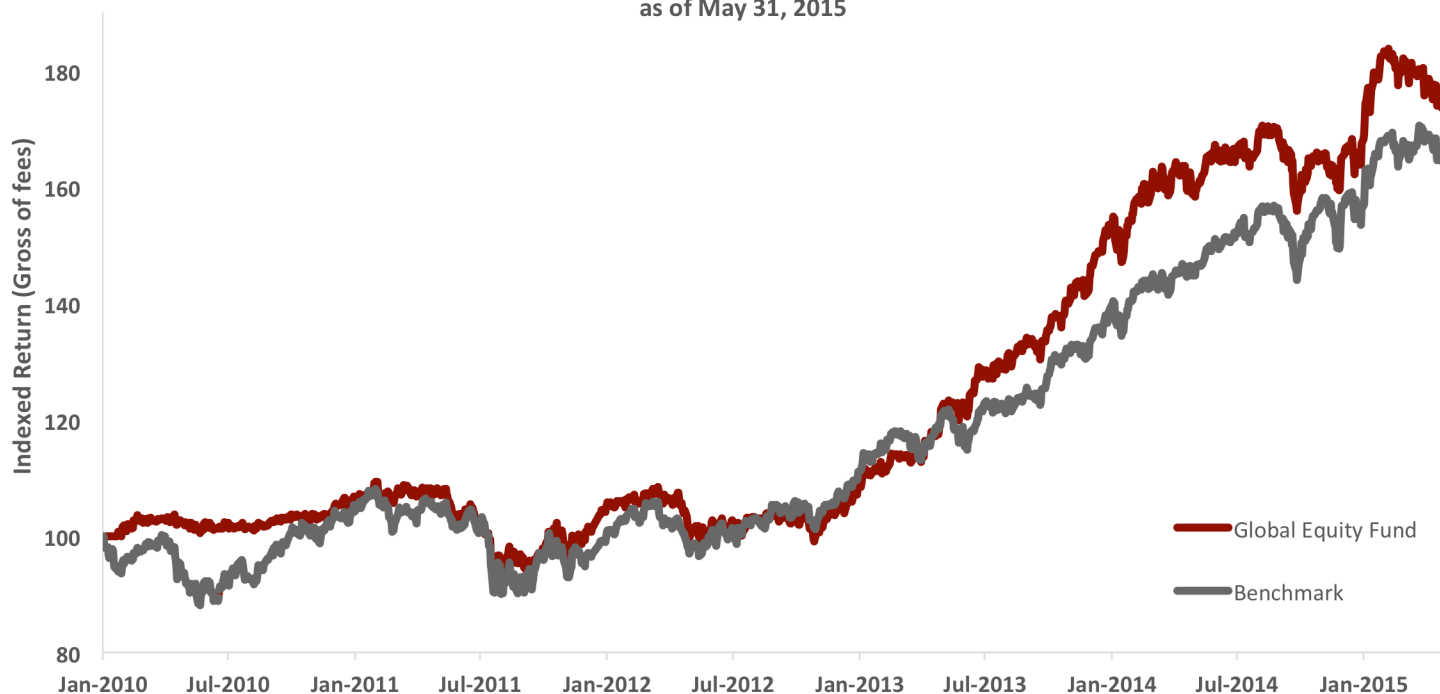
We are very pleased to report that the Desautels Global Equity Fund returned 8.3% gross of fees in Q1 2015, outperforming our benchmark by 2.7%. Based on our economic outlook for the US and Canada, we had been overweight USD compared to our benchmark by approximately 20%. Our Q1 outperformance was driven in large part by the 9.2% USD rally versus the Loonie. YTD the fund is up 8.9% versus 6.6% for the benchmark.

Global Equity Fund Returns				As of May 31, 2015
Time Period	Gross Return	Net Return	Benchmark	
Q1 2015	8.3%	7.9%	5.6%	
Q4 2014	(0.0%)	(0.4%)	2.6%	
YTD	8.9%	8.3%	6.6%	
1 year	12.3%	10.5%	14.7%	
2 year*	21.2%	19.3%	17.7%	
Since Inception*	11.7%	10.1%	10.2%	

\*Returns are annualized. Fund inception date is January 20, 2010

Global Equity Fund - Sector Allocation		As of end of Q1, 2015	
Sector	Global Equity Fund	Benchmark	(+/-)
Information Technology	20.2%	9.5%	10.7%
CAD	4.3%	0.0%	4.3%
USD	1.2%	0.0%	1.2%
Materials	8.9%	8.3%	0.6%
Telecommunication Services	3.7%	3.8%	-0.1%
Utilities	2.2%	2.5%	-0.3%
Health Care	7.3%	8.7%	-1.4%
Industrials	7.2%	9.2%	-2.0%
Consumer Staples	4.0%	6.1%	-2.1%
Energy	12.2%	15.7%	-3.5%
Financials	23.5%	27.1%	-3.6%
Consumer Discretionary	5.1%	9.0%	-3.9%

**Global Equity Fund Performance Since Inception**  
as of May 31, 2015



Note: Benchmark is the MSCI World Index from inception to February 28, 2013 and a 60% S&P TSX, 40% S&P 500 (measured in CAD) blended benchmark thereafter. Fund inception date is January 20, 2010.

## Market Commentary and Outlook

The S&P 500 had an up-and-down start to 2015, falling below 2,000 at the start of January, but climbing to over 2,115 less than a month later. It closed out the quarter up a mere 1.0% from the start of the year. Similarly, the TSX returned 1.8% for the first quarter of 2015. A 3% dip in the TSX Capped Financials Index was partially offset by a 2.4% rally in the TSX Capped Utilities Index.

Despite fears surrounding a breakup of the Euro Zone, overall equity market fears have subsided due to a steady recovery in the price of crude oil and strong economic data from Europe. The VIX volatility index ended Q1 at 15.3, down from 19.2 at the end of 2014.

Looking forward, our key macro and market views that will accompany our bottom-up analysis are as follows:

### (I) Continued Confidence in the US Economy

In April, the US unemployment rate fell to 5.4%, its lowest rate in over 6 years. Of course, these numbers need to be interpreted carefully. A key concern remains the declining labour force participation rate. One key metric that we monitor is the spread between U6 and U3 unemployment figures. U3 represents the official unemployment rate, whereas U6 also accounts for discouraged workers and part-time workers. Indeed the U6 rate remains quite high at 10.8% and a lot of market skeptics cite this figure as evidence that the US economy is in trouble. But note the 10.8% figure is down from a high of 17.1% in October 2009. Moreover, the spread between the U6 and U3 rates has declined to 5.4%, compared to an average spread of 7% in 2010. Thus, while we remain cautious on employment numbers, we note the positive medium term trend. We also believe that sensible monetary policy will be supportive for equity markets (more details on monetary policy in the Fixed Income section).

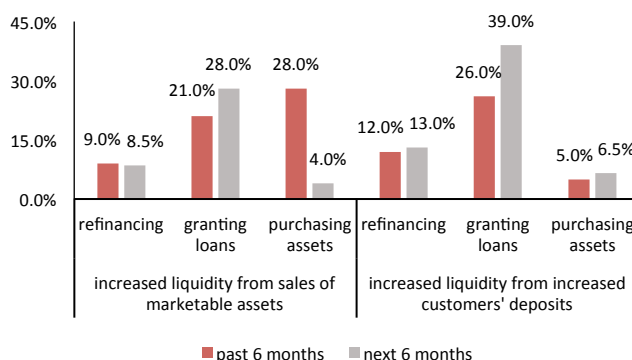
### (II) Increasing Confidence in Europe

We recently sold one of our two European holdings, bringing our overall Euro exposure down to just 4.5% of the fund. We are not, however, bearish on the European macro landscape. Despite the fears of Greece exiting the Euro Zone, we view the early success of the ECB's Quantitative Easing program as a signal for renewed market confidence in European markets.

In Q1, European ETFs experienced a \$35 billion inflow of capital from North America, compared to \$11 billion in the same quarter last year. Looking more closely at these inflows, we see that there was \$372 million that flowed into inflation linked bond ETFs, the largest amount since Q3 2010, when inflation in the Euro Zone was rising. These European inflows were accompanied by a simultaneous outflow of \$39 billion from American ETFs, signaling that Mario Draghi seems to be gaining the confidence of investors as he tries to kickstart the stagnant European economy.

On a fundamental basis, we can see the effects of QE starting to have an impact on European financial institutions. In an April survey conducted by the ECB, it was reported that of the increased liquidity from the expanded Asset Purchase Program that banks were receiving, over 24% was going towards granting loans to enterprises

Exhibit 1: Euro Bank Uses of Liquidity from Extended APP



Source: April 2015 ECB Bank Lending Survey

and individuals (Exhibit 1). This is well above the second highest purpose of refinancing, which represented approximately 8% of liquidity usage.

Overall, we remain positive on the European landscape, but are cautious of the possibility of a Greek exit. We take solace in the fact that our lone European holding, Intesa Sanpaolo, a leading Italian bank, has minimal exposure to the Greek economy, and should not be heavily affected should Greece fail to reach an agreement with their creditors.

### (III) Further Divergence from the Bank of Canada

In what has been a year characterized by diverging monetary policy from central banks around the world, Stephen Poloz and the Bank of Canada continued this trend when they surprised markets by announcing a 25 bp cut to its benchmark interest rate. Governor Poloz called the cut "insurance" against low oil prices and their potential harm to the Canadian economy.

We remain concerned about the elevated levels of household debt in Canada as well as the overheating housing market. In 2014, credit market debt held by Canadian households hit a record high, climbing to 162.6% of disposable income. With the recent hit to regional economies in oil producing areas, household debt risks are beginning to heat up once again. Furthermore, the IMF recently suggested that Canadian home prices were overvalued by as much as 20%.

As a result of our relative economic outlook in the US and Canada, and the flow of ideas from our bottom-up analysis, we have been effectively overweight USD exposure for some time now. While this has paid off in Q1, and we remain positive on the US, we are looking to trim this overweight USD exposure as prudent risk management. We remain a bottom-up fund and will continue to rely primarily on stock selection as a means of generating alpha.

### (IV) Valuations: High, But Not a Cause for Concern

Exhibit 2 compares current S&P 500 valuations at the end of Q1 2015 to historical averages based on a variety of metrics. The S&P 500 index currently trades at a NTM P/E of 16.9x, 22% above its historical 10 year average. Despite the Index trading above 5, 10, and 25 year averages on price-to-earnings, as well as P/B and P/CF, we feel that

given current market conditions, higher valuations are reasonable. The lower interest rate environment justifies a lower earnings yield on the S&P 500.

## Exhibit 2: S&P 500 Current and Historical Valuations

Current S&P 500 Valuations		Historical Perspective				
Valuation Measure	Description	Mar. 31, 2015	1-year ago	5-year avg.	10-year avg.	25-year avg.
P/E	Price to Earnings	16.9x	15.5x	13.6x	13.8x	15.7
CAPE	Shiller's P/E	27.8x	25.9x	22.7x	22.9x	25.4
TTM Div. Yield	Divident Yield	1.9%	1.9%	2.0%	2.0%	2.1%
REY	Real Earnings Yield	3.9%	4.2%	5.0%	4.5%	2.9%
P/B	Price to Book	2.8x	2.7x	2.3x	2.4x	2.9x
P/CF	Price to Cash Flow	11.8x	11.1x	9.4x	9.7x	11.3x
EY Spread	EY Minus Baa Yield	1.4%	1.7%	2.2%	1.3%	-0.6%

Source: JPMorgan Guide to the Markets

## Exhibit 3: Characteristics of Past Bear Markets

Characteristics of Past Bear Markets							
Market Corrections	Cycle Peak	Bull Market Duration Months	Decline from All-Time High	Recession	Commodity Shock	Fed Tightening	Extreme Valuations
Crash of 1929	Aug-29	37	-84%	✓	✗	✗	✓
1937 Fed Tightening	Feb-37	22	-74%	✓	✗	✓	✗
Post WWII Crash	May-46	48	-54%	✓	✗	✗	✓
Flash Crash of 1962	Dec-61	14	-22%	✗	✗	✗	✓
Tech Crash of 1970	Dec-68	73	-29%	✓	✓	✗	✗
Slagflation	Dec-72	29	-43%	✓	✓	✗	✗
Volker Tightening	Nov-80	31	-19%	✓	✓	✓	✗
1987 Crash	Aug-87	59	-27%	✗	✗	✗	✗
Tech Bubble	Aug-00	118	-42%	✓	✗	✗	✓
Global Financial Crisis	Oct-07	55	-51%	✓	✓	✓	✗

Source: JPMorgan Guide to the Markets

Building on this point, Exhibit 3 displays the characteristics of past bear markets, dating back to the Great Depression. Not surprisingly, the most common factor present in the last 10 bear markets was an economic recession (8 of 10). Note, however, that in only 4 of the 10 bear markets were equity valuations at extreme levels.

## (V) And Let's Not Forget About Oil

Crude oil began 2015 on the same note as it ended 2014: in free fall. The WTI Index opened the new year at \$52.80/bbl and proceeded to fall 17.6% in the following month to a new low of \$43.51. From there, it rebounded to \$54.11 within a week, but over the next month and a half erased all gains by dropping to a record-low \$41.81/bbl on March 18. WTI closed out the quarter up slightly from its 5-year low at \$49.60/barrel. WTI continued on this upward trend in the past few weeks and is currently near \$60. These upticks in the market have been accompanied by a counter-intuitive increase in the supply of oil coming from the United States. In the first 3 months of 2015, US Crude Oil production increased from approximately 9.1mm bbl/d to 9.4mm bbl/d, all of this while US Oil Rig Count has fallen 53% since October 2014 to a 4-year low of 760 rigs. Upstream producers have been shutting down their least efficient wells, while bolstering production in their highest quality sites, driving US Crude production to new highs.

Of course, this production will not be able to keep up forever, and it is expected that we will see a supply reduction of 0.8mm bbl/d over the next year as some of the best oil rigs in the US begin to taper off. As it stands, the global market for crude oil is over-supplied by 1-2mm bbl/d. As we move into the summer months, global demand is

set to tick-up by <2mm bbl/d, which when coupled with a tailing off of US production, can give us a line of sight to a balanced market.

This, however, does not provide us with an absolute resolution, as the issue of high storage levels continues to persist. With Cushing, Oklahoma storage levels at all time-highs, and many of the off-shore tankers reaching storage levels in excess of 80%, there has been widespread concern that we are headed for another free fall in oil prices. As futures traders around the world run out of space to store the oil they are buying in the spot market in hopes of selling in the future at higher prices, they will have no other option than to sell their barrels of crude. Once this happens, we could see another plummet in crude oil prices.

One factor that could counteract this double-dip price cycle in oil is an unexpectedly swift rise in US road travel, coupled with soaring Chinese demand for fuel-hungry sport utility vehicles. This surprise demand has helped offset the supply glut in crude that had so many worried at the start of the year.

From an investment perspective, the current oil price environment provides a wealth of opportunities to the educated investor. We at DCM will continue to look at three different opportunities for relatively stressed business models to skate back on side. Primarily, we look for companies capable of rationalizing or improving corporate fundamentals, with potential of achieving better than guided capital efficiencies. Companies in this space currently on our watch list include Tamarack Valley Energy. Secondly, we look for companies that could look to improve upon their sustainability outlook through realistic reduction in capital or dividend programs, such as MEG Energy, which we have owned since November 2013. Finally, we are always on the watch for companies that could look to M&A opportunities as a mechanism for corporate survival.

## Overview Summary

While we still favour the US macro landscape compared to Canada, we will look to reduce our overweight exposure to the US dollar, and continue to focus on stock selection as a means of generating returns. We remain bullish on the Euro Zone economy, as early results from the ECB's Quantitative Easing program show increased credit from banks to both enterprises and individuals.

## Holdings: Q1 Winners and Losers

In this section, we highlight some of our key individual holdings:

### Amazon.com (NASDAQ: AMZN) – Up 20.6% in Q1

We purchased Amazon in November of last year, with the conviction that the company's competitive advantage and economic moat, which is a result of its significant reinvestment in the business, will drive long-term growth as the E-Commerce market continues to expand both in North America and across the globe. Since initiating our position 5 months ago, Amazon has been the portfolio's best performer.

Much of Amazon's recent appreciation has been a result of the company's Q4 earnings release on January 29. Earnings per share came in at \$0.45, which topped consensus estimates of \$0.18. The

beat was largely driven by significant growth in the Amazon Prime segment, which is a “one-of-a-kind, physical-digital hybrid.” The market was ecstatic with Amazon’s surprise profitability, as the share price jumped 13.5% on the day of the announcement.

Moving forward after this earnings announcement we believe there is still a fair amount of value to be realized with Amazon. DCM’s view is that the company’s long-term cost structure is more attractive than the world’s largest existing retailers, and that this will serve as a major barrier to entry should other players try to enter the E-Commerce space. Additionally, we are confident in the company’s ability as a disruptor in multiple different segments. Amazon Prime, Amazon Video On Demand, Amazon Web Services and the Amazon Kindle are all part of a diverse revenue mix that the company has built up through reinvesting in the business. We foresee the cross-selling capabilities between these segments to contribute significantly to Amazon’s growth in the coming years.

## **Intesa SanPaolo (BIT: ISP) – Up 29.0% in Q1**

Intesa SanPaolo is a good example of an investment made by DCM where the thesis played out exactly how and when we thought it would.

In October, the European Central Bank announced the results of the Asset Quality Review Test, where Intesa outperformed its 14 Italian banking peers. Intesa had a mere .3% reduction to its Common Equity Tier 1 Ratio, compared to its peer average of a 1.1% reduction. As was the original thesis for Intesa, the ECB AQR served as the turning point for the market to realize the bank’s strong capital position and superior operating capability compared to its peers.

Furthermore, the onset of Quantitative Easing in the Euro-Zone, which officially got underway in late February, has been a big boost to the European Financials industry as the ECB tries yet another measure to spur liquidity and credit in the market. So far, it would appear as if these measures are working. Data published by the ECB at the end of March indicated that lending to European corporates increased by \$8 billion in the month of February, and loans to households increased by \$1 billion. Moreover, the Euro-Zone is seeing a broad expansion of its M1 money supply, with the figure rising 8.9% and 9.1% in January and February, respectively.

All in all, these factors have given huge momentum to Intesa’s stock price. Year to date, Intesa’s shares are trading up 41.5% vs. the European Financials benchmark, which is only up 4.3%. Note that DCM owns the ADR for Intesa, which has been affected by the weakness of the Euro vs. the US Dollar, hence our 29% return.

Moving forward, we remain bullish on the bank for a variety of reasons. First and foremost, it boasts one of the strongest capital positions against many of its peers struggling to match the wishes of regulators. It also offers the best dividend yield in the market in a context of low interest rates. Finally, it has significant exposure to the growing Italian asset management business, which accounted for over 40% of the group’s profits in 2014.

## **Intel (NASDAQ: INTC) – Down 13.4% in Q1**

After a red-hot 2014, where the stock appreciated more than 43%, Intel has had a sluggish start to 2015. The recent cooling off can be attributed to market pessimism over Intel’s reliance on PCs. While it is true that the company’s Client Computing Group revenue declined 8% year over year in Q1, this drop was fully offset by big jumps in revenue from the Data Center and Internet of Things business units. Data Center revenue grew 19% for the first quarter, which is huge for Intel given that the operating margins in this segment are the company’s largest, at around 50%.

A high degree of negative sentiment has been surrounding Intel, given that it operates in a highly cyclical & capital intensive business subject to rapid change. The heavy dependence on a mature PC market that is struggling with competition from tablets, weak economy, and new PC forms, is leading to wide selloffs in the company’s stock. Furthermore, the company lacks competitiveness in its mobile & wearable devices technology, leading to greater sentiment that Intel has been too far behind the ball in an ever-changing industry.

In short, the main risk for Intel going forward is that the company derives roughly 60% of revenue from the consumer PC segment. If PC demand is weaker than expected, Intel’s top line will be adversely affected. However, we at DCM believe that the market is over-discounting Intel based on their PC reliance. We believe that the company will continue to capitalize on its high runway for growth in its Data Center and IoT segments, reducing its overall revenue mix away from PC. They have already shown signs of this in their most recent earnings release, and we believe this to be a driver of value in the coming year.

## **Pangaea Logistics Solutions (NASDAQ: PANL) – Down 41.8%**

Pangaea Logistics Solutions provides seaborne transportation services for dry bulk commodities worldwide. We initiated a small position in the company at approximately 1.3% in early November 2014.

Pangaea has been dragged down into deep waters by the Baltic Dry Index, which reached a 29-year low in February, and is down approximately 59% from its mid-November high of 1464. The slowing growth coming from China and other emerging markets has hampered the Index, which is often used as a proxy for future global economic growth, as it measures the cost of moving raw materials across the globe. Adding fuel to the fire is the fact that there is a large oversupply of megaships that have come online in the past 1-2 years, which have reduced the costs of shipping and driven the index down even further.

Despite a steep drop in Pangaea’s share price, we remain unchanged in our buy rating on the stock. The thing to note about the current downturn in the Baltic Dry Index is that these low prices will inherently cause a spur in demand from global economies. The ramp up in megaship production has led to record low prices of moving dry bulk commodities, making it that much cheaper for companies and governments to invest in infrastructure and construction.

Going forward, we expect Pangaea to be a prime beneficiary of a rebound in the Dry Baltic Index, as it is able to capitalize on its value-added backhaul specialization, where it has differentiated itself through increasing the amount of bulk it carries on backhaul routes. Furthermore, the company has a dominant presence in Arctic shipping, giving us confidence that this downturn in share price is merely related to the industry cycle, and not company specific.

## Recent Portfolio Additions

During the first quarter of 2014, we initiated positions in the following companies: Western Forest Products Inc. (TSX: WEF), Marathon Petroleum Corp (NYSE: MPC), and Lannett Co (NYSE: LCI).

### Western Forest Products (TSX: WEF)

Western Forest Products is a Canadian lumber producer engaged in timber harvesting and manufacturing of wood products. They operate solely in British Columbia, owning 7 sawmills representing 1.1 billion board feet of production capacity. Western Forest Products has a highly diversified and flexible revenue structure, both geographically and by product type, which will allow the company to benefit from a changing macroeconomic environment more so than its peers. Additionally, the Canadian forestry industry is set to benefit from the recovery of the US housing market, which is expected to be fully realized within the next couple of years. Both of these factors are magnified by an approximate 30% discount which WEF is currently trading at on an intrinsic and comparable company valuation.

### Marathon Petroleum Corp (NYSE: MPC)

Marathon Petroleum Corp. is a fully integrated American midstream and downstream company that focuses on refining, transporting, and marketing petroleum products. The company has strategically located assets, which allow it to benefit from refining trends in the Midwest and the Gulf Coast. As well, they recently acquired Speedway and Hess, two of the top performing retail gasoline players in the United States. These acquisitions create significant economies of scale as it turns Marathon into a more vertically integrated player. We entered our position in Marathon back in January, when there was a lot of negative investor sentiment towards the energy sector. Our view was that Marathon was a baby thrown out with the bathwater, and that the company was being overly punished by the market for the short term tightening of the WTI crack spread, which measures the spread between the sale price of refined products and WTI. Since initiating our position, our thesis has played out and we have realized a gain of 13.4%.

## DCM Company Update

The changing of seasons brings with it an annual transition period here at DCM. As our Senior class of analysts move on to their respective careers, we are sad to see them go, but thankful for all they have given in their two years of service to the firm. Their dedication, knowledge, and passion for our program has done wonders not only for our Junior analyst class, but for Desautels Capital Management as a whole. The incoming Seniors have large shoes to fill, but I am confident in our team's ability to build upon what has been left behind by such an outstanding group of analysts.

I am honoured to have been elected as the new Equity Strategist and I look forward to serving DCM and our investors in the year ahead. I would like to thank our former Equity Strategist, Belal Yassine, whose vision and leadership has helped DCM make tremendous strides over the past 12 months. His mentorship during the past year has been invaluable to not only myself, but to my 10 junior colleagues as well.

To our investors, we are reminded of your generous investment in the fund and your continuous support of the program. I speak on behalf of myself and the rest of the students here at DCM when I say that your generosity is having a profound impact on our university experience each and every day. We look forward to another exciting year.

Sincerely,

Drew Allen

Global Equity Strategist

Exhibit 4: DCM Holdings as of end of Q1 2015

Global Equity Fund - Holdings List as of (31-03-2015)									
#	Security Name	Sector	Currency Exposure	Size	# of Units	Local Cost / Unit	Local Price / Unit	Base Market Value	Position Size %
1	ISHARES S+P/TSX CAPPED FINAN	Financials	CAD	ETF	5,760	\$30.89	\$30.73	\$177,005	6.1%
2	GENERAL MOTORS CO	Industrials	USD	Large	3,690	32.01	37.50	175,252	6.0%
3	MEADWESTVACO CORP	Materials	USD	Mid	2,330	42.96	49.87	147,164	5.0%
4	INTESA SANPAOLO SPON ADR	Financials	EUR	Large	5,410	19.23	20.38	139,639	4.8%
5	YUME INC	Information Technology	USD	Small	21,160	5.74	5.19	139,088	4.8%
6	WELLS FARGO + CO	Financials	USD	Large	2,011	32.68	54.40	138,553	4.8%
7	CANADIAN DOLLAR	CAD	CAD	Cash	126,649	1.00	1.00	126,649	4.3%
8	NEW YORK REIT INC W/D	Financials	USD	Mid	9,300	11.06	10.48	123,438	4.2%
9	TERADATA CORP	Information Technology	USD	Mid	2,184	43.28	44.14	122,093	4.2%
10	VASCULAR SOLUTIONS INC	Health Care	USD	Small	3,150	28.11	30.32	120,961	4.1%
11	PULSE SEISMIC INC	Energy	CAD	Small	40,973	2.89	2.88	118,002	4.0%
12	CAPITAL ONE FINANCIAL CORP	Financials	USD	Large	1,132	73.01	78.82	113,003	3.9%
13	BCE INC	Telecommunication Services	CAD	Large	2,025	40.38	53.62	108,581	3.7%
14	ISHARES GLOBAL CONSUMER STAPLE	Consumer Staples	USD	ETF	920	87.21	91.57	106,696	3.7%
15	MEG ENERGY CORP	Energy	CAD	Mid	5,195	33.15	20.46	106,290	3.6%
16	AMAZON.COM INC	Information Technology	USD	Large	220	306.75	372.10	103,678	3.6%
17	PERFORMANCE SPORTS GROUP LTD	Consumer Discretionary	CAD	Small	3,485	12.96	24.71	86,114	3.0%
18	TIME WARNER INC	Information Technology	USD	Large	800	82.71	84.44	85,555	2.9%
19	INTEL CORP	Information Technology	USD	Large	2,065	25.32	31.27	81,781	2.8%
20	PAREX RESOURCES INC	Energy	CAD	Mid	8,060	7.30	8.07	65,044	2.2%
21	BMO EQUAL WEIGHT UTIL IDX ET	Utilities	CAD	ETF	4,065	15.76	15.83	64,349	2.2%
22	TJX COMPANIES INC	Consumer Discretionary	USD	Large	700	62.98	70.05	62,103	2.1%
23	MARATHON PETROLEUM CORP	Energy	USD	Large	470	88.29	102.39	60,948	2.1%
24	STMICROELECTRONICS NV NY SHS	Information Technology	EUR	Mid	4,975	9.31	9.27	58,409	2.0%
25	MCEWEN MINING INC	Materials	CAD	Small	45,000	1.50	1.27	57,150	2.0%
26	LUNDIN MINING CORP	Materials	CAD	Mid	10,500	4.85	5.11	53,655	1.8%
27	ISHARES GLOBAL HEALTHCARE ETF	Health Care	USD	ETF	350	87.47	107.81	47,789	1.6%
28	LANNETT CO INC	Health Care	USD	Mid	500	61.17	67.71	42,877	1.5%
29	US DOLLAR	USD	USD	Cash	29,244	1.00	1.00	37,037	1.3%
30	PANGAEA LOGISTICS SOLUTIONS	Industrials	USD	Small	10,749	5.38	2.66	36,212	1.2%
31	COLABOR GROUP INC	Consumer Staples	CAD	Small	9,640	4.27	1.07	10,315	0.4%
Total						\$2,915,429		100.0%	

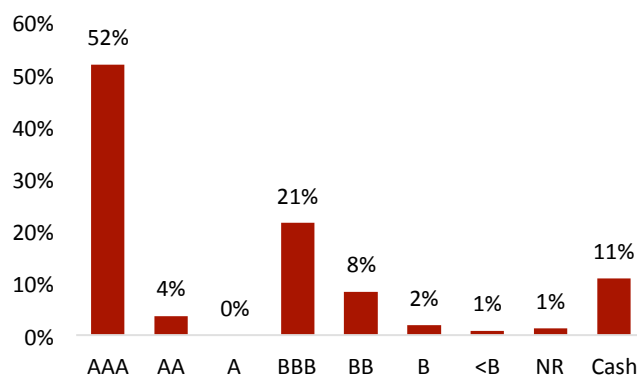
Dear Investor,

The Desautels Fixed Income Fund returned 6.4% (gross of fees) in Q1 2015. Strong Q1 performance was due to falling interest rates amid lower than expected inflation coupled with renewed concerns on global economic growth. We slightly underperformed our benchmark's 7.0% Q1 return due to a lower duration position, particularly when the Bank of Canada cut rates in January. Our lower duration, however, helped us outperform since the end of Q1 as interest rates reversed course and began rising. In 2015 the Fixed Income Fund is up 5.1% through May 31, vs 4.7% for our benchmark.

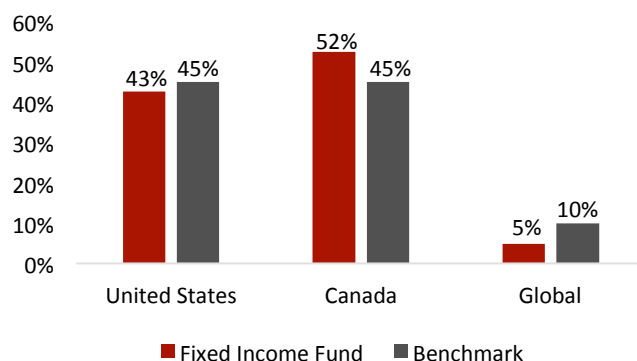
Fixed Income Fund Returns		As of May 31, 2015	
Time Period	Gross Return	Net Return	Benchmark
Q1 2015	6.4%	6.3%	7.0%
Q4 2014	2.1%	2.0%	3.2%
YTD	5.1%	4.9%	4.7%
1 year	9.0%	8.5%	9.8%
2 year*	7.2%	6.7%	7.0%
Since Inception*	5.1%	4.5%	4.4%

\*Returns are annualized. Fund inception date is January 20, 2010

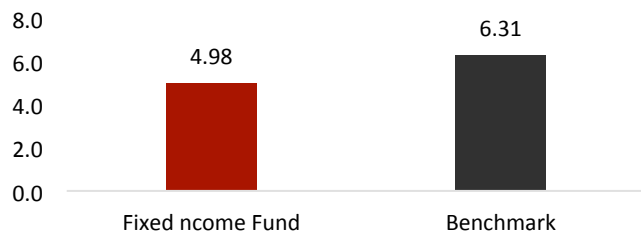
Credit Rating Distribution  
As of end of Q1, 2015



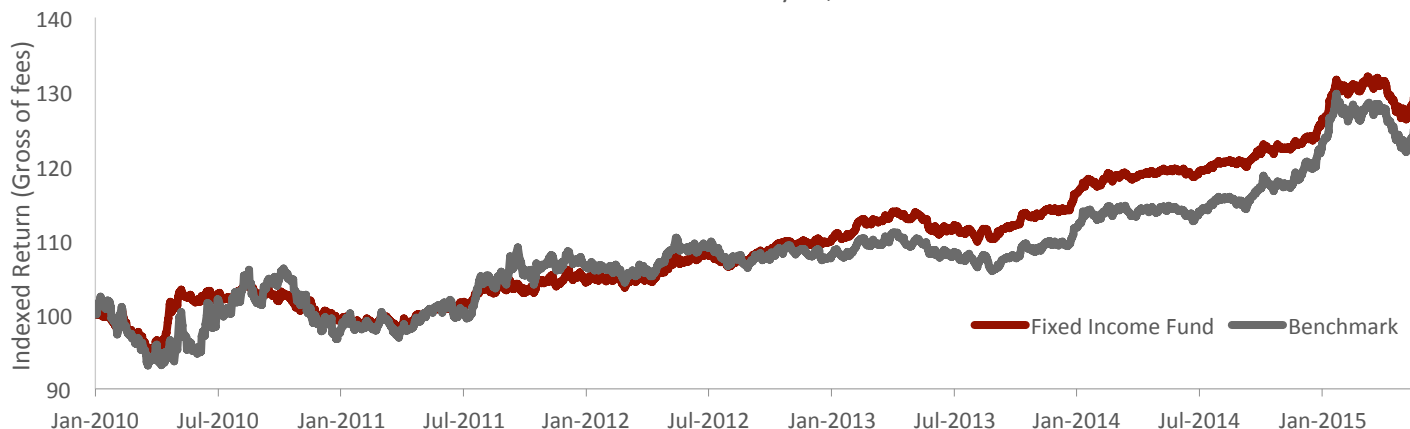
Currency Allocation Versus Benchmark  
As of end of Q1, 2015



Duration Versus Benchmark  
As of end of Q1, 2015



Fixed Income Fund Performance Since Inception  
as of May 31, 2015



Note: Benchmark is a blended Barclays US Aggregate Total Return Value Index (45%), Dex Universe Bond Index (45%) and S&P/Citigroup International Treasury Bond Ex-U.S. Index (10%). All indices are measured in CAD. Inception date is January 20, 2010.

## US Macro

The US treasury yield curve shifted down and flattened significantly in Q1, with key maturities of 5Y and beyond declining by ~25bp while the 2Y declined by 11bp and the 1Y yield remained roughly unchanged (Figure 1). The bull flattening can be partially attributed to January's lower than expected headline inflation figure of -0.7% m/m. Medium and long-term yields declined further due to a flight to safety triggered by the market's renewed pessimism surrounding US economic growth following disappointing existing home sales and jobless claims. Problems in the Eurozone, the slowdown of Chinese growth and the rate cutting trend of global central banks also put downward pressure on US treasury yields.

While yields have fallen, interest rate uncertainty spiked in Q1, with realized volatility on the US 10Y reaching levels not seen since 2011 (Figure 2). This is not entirely surprising given the mixed US economic data seen in Q1. While unemployment reached a seven-year low of 5.5% and industrial production remained stable at around 4% y/y growth, both consumer confidence and new manufacturing orders declined YTD. Furthermore, negative US economic surprises, as measured by the Citi Economic Surprises Index, hit a two-year low in late March, and housing sales have been quite volatile despite historically low mortgage rates.

## US Outlook and Duration

Looking ahead, we remain relatively bullish on the US economy, despite the above mentioned mixed signals. Of particular importance, in our view, is a strong consumer sector supported by low financing rates. Indeed, delinquency rates have reached pre-2008 levels and consumer spending is strong, growing over 3% y/y in both January and February 2015. In addition, labour participation rates have now begun stabilizing and disposable personal income growth is accelerating. To be sure, the accelerated consumer savings growth rate of 20.4% seen in February y/y is a concern for short term economic activity, and one reason we are only mildly bullish.

We believe the US economy will grow *slowly* but surely, resulting in a longer than average economic cycle. The deleveraging of corporate and household balance sheets have plateaued, and the output gap still stands at 3% of potential GDP, suggesting there is room for further economic recovery, particularly with an accommodative monetary policy. The main risks facing the US economy are shocks from overseas. However, as we discuss below, global central banks are increasingly taking a supportive stance and providing downside protection for asset prices. In short, we are cautious of potential volatility in this phase of slow expansion but remain optimistic on US economic growth.

On the monetary policy front, the Fed has dropped the word "patient" from their March minutes and lowered forecasts for unemployment, but also lowered forecasts for GDP growth and inflation. Overall, the Fed appears to be maintaining a dovish stance and the policy rate increase is expected to be very gradual. As a result, the market pushed expectations for the first rate hike from June and as of the end of Q1, Fed Futures prices were indicating an equal probability of a first hike happening in October 2015, December 2015, or January 2016.

We think the current monetary policy stance creates an asymmetric profile in favor of higher rates. The Fed finds itself in an interesting situation where overall positive economic growth is not strong enough to warrant a rate increase but not weak enough to renew non-traditional stimulus programs. One might argue that longer term yields in the US are still too high compared to other G7 countries. For example, German 10Y yields are hovering around 0.3%. Moreover, the US is the only G7 country with positive real interest rates. But we don't see US yields falling much further. Economic data in the US is upward trending for the most part, and unlike their G7 counterparts, the Fed is not likely to engage in further QE. Indeed, the unwinding of QE poses a serious upside risk to US yields. Even a drop in the dovish tone by the Fed could trigger a selloff. At the FOMC meeting in April, although the Fed highlighted economic weakness, it left the door open for a June hike, and the 10Y yield was up 4bp.

Because of our relatively bullish view on the economic growth and the limited downside to interest rates, we prefer to retain our short duration positioning in the US. Our current US duration stands at 3.1 years compared to 5.1 for our benchmark. In our view, the marginal benefit of extending our duration does not justify the large potential downside. Thus, we retain a shorter duration in the US relative to our benchmark.

## Canada Macro

The Canadian yield curve is telling its own interesting stories. We saw an overall downward shift due to the BoC policy rate cut in late January, and the key maturities under 5Y have largely flattened, while key maturities beyond 5Y have largely steepened (Figure 3). The curve is slightly inverted until 2Y, and upward sloping beyond that. The shape of the yield curve suggests that the market is expecting difficult economic growth in the next 2 years and meaningful economic expansion only after 2016.

The market is slightly more pessimistic than the BoC. In its Monetary Policy Report in January, the BoC expected real GDP growth to slow to ~1.5% and the output gap to widen in 1H15. The report also projects that Canada's non-energy economy would gradually strengthen later in the year and real GDP growth would pick up to 2.25%-2.5% in 2H15 until 2016. In the April Monetary Policy Report, the BoC slightly revised down its 2015 growth guidance, revised up its 2016 growth guidance and maintained the belief that the economy will reach full capacity by 2016 year end.

## Canada Outlook and Duration

At DCM, we agree with the market's pessimism and we have expressed our relatively bearish view on the Canadian economy in previous newsletters. In 2015 and 2016, we see lower than expected growth in non-energy sectors as the main reason to be bearish on Canada.

The BoC's growth forecast is heavily relying on non-energy sectors to re-emerge as dominant contributors by mid-2015, bolstered by stronger US activity and a weaker Loonie. However, we believe the pickup in non-energy investment and exports will likely be muted for the following reasons. First, the BoC's most recent assumption for US GDP growth, the destination of 75% of Canadian exports, is higher

than the Fed's own forecast by ~0.3% for both 2015 and 2016. Second, non-energy export growth will be constrained by productive capacity in the near future and investment will be needed to support growth, as industrial utilization is at 83.6%, above the average rate of previous economic expansions. Lastly, there is considerable uncertainty around how quickly business investment in non-energy sectors will respond, but the BoC is assuming 7% growth in investment outside the oil and gas sector, which is very high considering there was no growth in 2014. In addition, the Spring Business Outlook Survey showed a second quarterly decline in investment intention.

In terms of inflation, DCM forecasts headline inflation will remain at its current subdued level, after dropping to 1% in the first months of 2015. On a positive note, we believe the housing market will remain balanced in 2015, as housing prices remained stable during the oil shock and the benchmark 5Y mortgage rate recently reached an all-time low, around 4.6%.

However, going forward, we do see more downside than upside for Canadian interest rates. Although the latest BoC meeting minutes indicate that a second rate cut is unlikely given the easing economic conditions since 2014 year-end, we believe there might be reasons to call for another cut. First, Governor Poloz has said that monetary policy is a risk management process, and he would be willing to cut the rate further should insurance for the economy be needed. Second, the rate cut would be necessary at some point if Brent does not stabilize at \$60, the price the BoC based its guidance on. The EIA report in March shows that crude oil storage capacity has reached 60%, up from 48% at the same time last year. If the trend of inventory accumulation continues, full capacity could be reached by the end of 2Q15 and the market would be flooded with supply. Although we expect oil demand to pick up during the 2015 summer as discussed in the Equity Outlook section, the tail risk of lower than expected oil demand would put downward pressure on the Canadian policy rate.

In addition, as analysts on the Street have pointed out, the BoC's credibility has diminished given Governor Poloz's self-contradiction in his various speeches. Just last year, Poloz said he would abandon explicit forward policy guidance and then surprised everyone with a January rate cut and a series of guidance; in January, he said he would take out more insurance if necessary and then declared the 0.75% overnight rate to be appropriate in February.

Given the confusion in monetary policy and asymmetric downside yield risk in Canada, we have been actively increasing our Canadian duration to match that of the benchmark. Given that the market is already pricing in our views, we prefer to match, not exceed, the benchmark's duration in Canada.

## International Macro

DCM has largely avoided international exposure in the past year, as we see credit fundamentals strengthening more in North America versus EMEA and Asia. The volatility of the European treasury market is back with mixed economic data coming out of Germany and uncertainties surrounding the Eurozone's bailout programs. Tensions between Russia and the Eurozone, slowdown of Chinese growth and

the approaching deadline for Iran's nuclear deal have all increased volatility in the emerging markets. Despite these risks, risk premia in EMEA and Asia has been declining as measured by their CDS indices.

Interestingly, central banks around the world are reacting to the global economic uncertainties in a similar fashion: fifteen countries have cut their key policy rates in the first three months of 2015 alone (Figure 4). Nineteen countries have done so since 2014. This strongly contrasts the rate hike expectations in the US and confirms our views that the US is well ahead of the economic cycle and might present better credit opportunities.

In early March, both China and India cut their rates again, their second surprise rate cut since in the last four months. This underscores the increasingly aggressive measures the Asian leaderships are relying on to stimulate economic activity. The Indian government's initiative to encourage infrastructure spending has resulted in accelerating industrial production and higher employment in recent quarters. Along with the oil slide pushing Indian CPI to 5% down from 8% a year ago, these measures have strengthened the Indian Rupee to the benefit of our sole international position, WisdomTree Indian Rupee ETF which returned 2.94% in Q1 in USD terms.

## Credit

Credit spreads reversed course in Q1, with IG tightening about 20bp and HY tightening by about twice as much. In previous newsletters we noted the deleveraging of Corporate America, as evidenced by declining leverage and coverage ratios. The ratios now appear to have stabilized, and a less pronounced deleveraging process in Canada has also now come to an end. In the IG space, we believe that it is increasingly difficult to find value in a volatile growth environment, as explained in the macro sections. Although the current IG spread is still above its pre-2008 level, the margin of safety is low. One has to look very carefully within the IG space to find attractive opportunities.

Given our relatively bullish view on the US economy, we favour the HY sector, to which we aim to allocate close to 15%, the maximum allowed under our Fund Policy. HY historically outperforms in an expansion phase as corporate fundamentals improve and credit spreads tighten. We believe default rates in the broad HY space will not rise materially above their 2015 2%-3% level. However, we remain cautious of the margin of safety that is becoming increasingly thin and emphasize a deep bottom-up analysis on credit names, particularly in Canada. In the US we are comfortable with our current allocation to the Barclays HY Bond ETF, but will be looking to shift into individual names as opportunities arise.

## Holdings

**Newalta (NALCN 5.88% 04/01/2021) – 3.43% YTD return**

Newalta is a pure-play energy waste management firm operating in Canada and the United States. It completed the sale of its Industrial Division in February 2015 and the proceeds are to be used to pay down its debt and reduce its Net Debt/EBIDTA ratio to below 2. Our investment thesis was that 1) the company is well-positioned in a favourable regulatory environment; 2) the company has great flexibility over Capex spending, two-thirds of which is discretionary

and largely tied to its M&A strategy; 3) its diversified revenue stream and business model would help the company weather through fluctuations in energy prices.

The first and second investment theses have proved robust, as Newalta's revenue in 4Q14 held steady despite reductions in Capex budgets from upstream firms, and the company cut its own Capex for 2015 by 45% to \$105M. In addition, Newalta announced cost cutting measures in February 2015 aiming at annual savings of \$20M going forward, further strengthening its financial position after the sale of the Industrial Division.

However, the market appears to be focusing only on oil prices. For example, Newalta's g-spread has a -0.95 correlation to the WCS spot price. As a result, the bond spread widened close to 140bp since the end of Q3, 2014. DCM believes the market is over-punishing Newalta as a result of being in the energy sector, and is ignoring points 1 and 2 mentioned above. Management estimates that for every \$10 decrease in WCS, there would be a decrease of \$4.4M in EBITDA, which represents a mere 3.4% decrease relative to 2014 EBITDA. Going forward, we expect spread tightening once it becomes apparent that the company's fundamentals are not as closely linked to oil prices as the market currently believes.

#### **Home Capital Group (HCG 3.4% 12/10/2018) – 1.93% YTD return**

Home Capital Group is a deposit-taking mortgage lender that operates in the Canadian non-prime market. It strategically targets immigrants and self-employed individuals whose official credit scores don't reflect their actual credit worthiness. Our investment thesis was that 1) the company is getting an increasing proportion of its revenues from stable servicing fees and taking relatively less credit risk; 2) the market is overlooking the company's strong risk management due to its operations in the non-prime market; 3) the Home Capital bond is discounted compared to similar bonds.

Indeed, Home Capital's credit profile has improved since we entered the position in December 2014, as it slowed its loan growth rate and improved its non-performing loan and regulatory capital ratios. At the same time, net interest income slightly decreased in Q4 2014 while non-interest income soared thanks to increasing servicing fees and realized P&L on the sale of securitized mortgages, meaning the overall revenue stream has become less volatile and less dependent on the Canadian housing macro picture.

Other credit positive developments include the application to be a Scheduled I Bank in Canada, expected to finalize by 2015 year-end. Management intends to leverage this status to enhance the Home Capital brand without incurring capex to open retail branches. We do like management's cautiousness regarding Capex and expense control, which result in Home Capital's industry-leading efficiency ratio.

However, the g-spread on Home Capital 2018 has widened some 30bp YTD due to concerns over the oil slide and its impact on the Canadian housing market. Going forward, however, we expect spread tightening due to the points mentioned above, and also given the company's very limited exposure to Alberta (2% of uninsured loans).

#### **Rona (RON 5.4% 10/20/2016) – 0.83% HPR**

Rona is a Canadian retailer and distributor of home improvement products. We entered the position on February 17, 2015 and our investment thesis was that 1) Rona would continue strengthening its balance sheet through its cost-cutting program, 2) it would leverage its competitive positioning in its core Quebec market, and 3) Rona 2016 is a highly discounted short-term bond that offers an attractive way to deploy cash.

In-line with our investment thesis, Rona has successfully achieved its \$110M cost-cutting program, as per the latest quarterly release. Going forward, 30% of these savings will be reinvested in the store network with the goal of driving sales growth and improving margins, while the remaining 70% represents a net annual savings of \$80M. Our second investment thesis also proved fruitful, as Rona reported 6% same-store-sales growth in 4Q14, which Management attributes to Rona's strong merchandising strategy and distribution channel to that topline growth.

Going forward, we expect to see further spread compression from Rona 2016, as its spread now stands at 260bp compared to 303bp at initiation. Nevertheless, Rona 2016 still remains an attractive short-term option to deploy cash compared to other short-term credit of similar rating.

#### **Fund Update**

We would like to thank our outgoing Fixed Income Strategist Daniel Sorek and the analysts who have worked hard in the Fixed Income Fund over the past year: Debra Kelsall, Pengchao Liu, Alexander Ohrn and Faicy Hussain. Their contributions have been instrumental to the Fund's development and we wish them the best in their future endeavours. We are also grateful for the expertise and best practices that previous strategists and analysts have provided to us, and we hope to pass on this knowledge to our new team of incoming Junior Analysts.

I am honoured to have been elected as the new Fixed Income Strategist. I look forward to dedicating my efforts to the Fund and our investors in the year ahead. We remain mindful of the generous and trusting support from our loyal investors, who made this unique learning experience possible. Thank you and we look forward to a great year ahead.

Sincerely,

Peter Huo  
Fixed Income Strategist

## Fixed Income Fund Exhibits

Figure 1: US Treasury Yield Curve

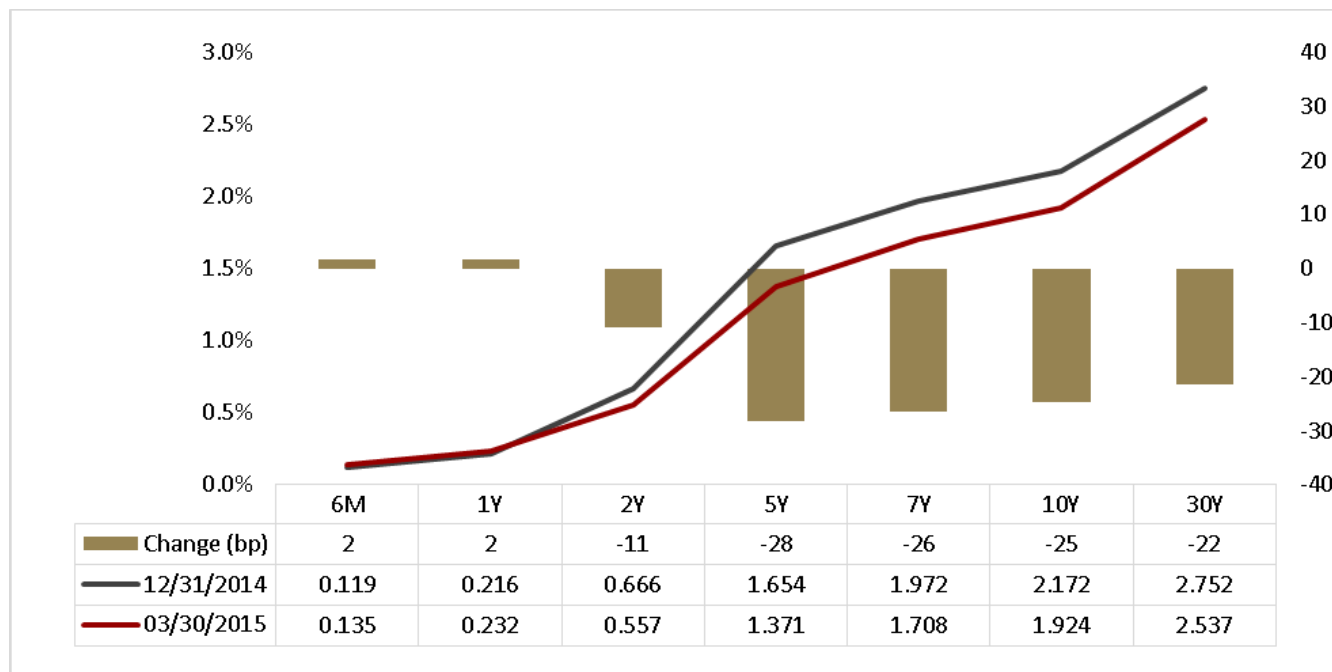


Figure 2: Volatility of the US 10Y Yield Reached a Four-Year High in Q1 2015

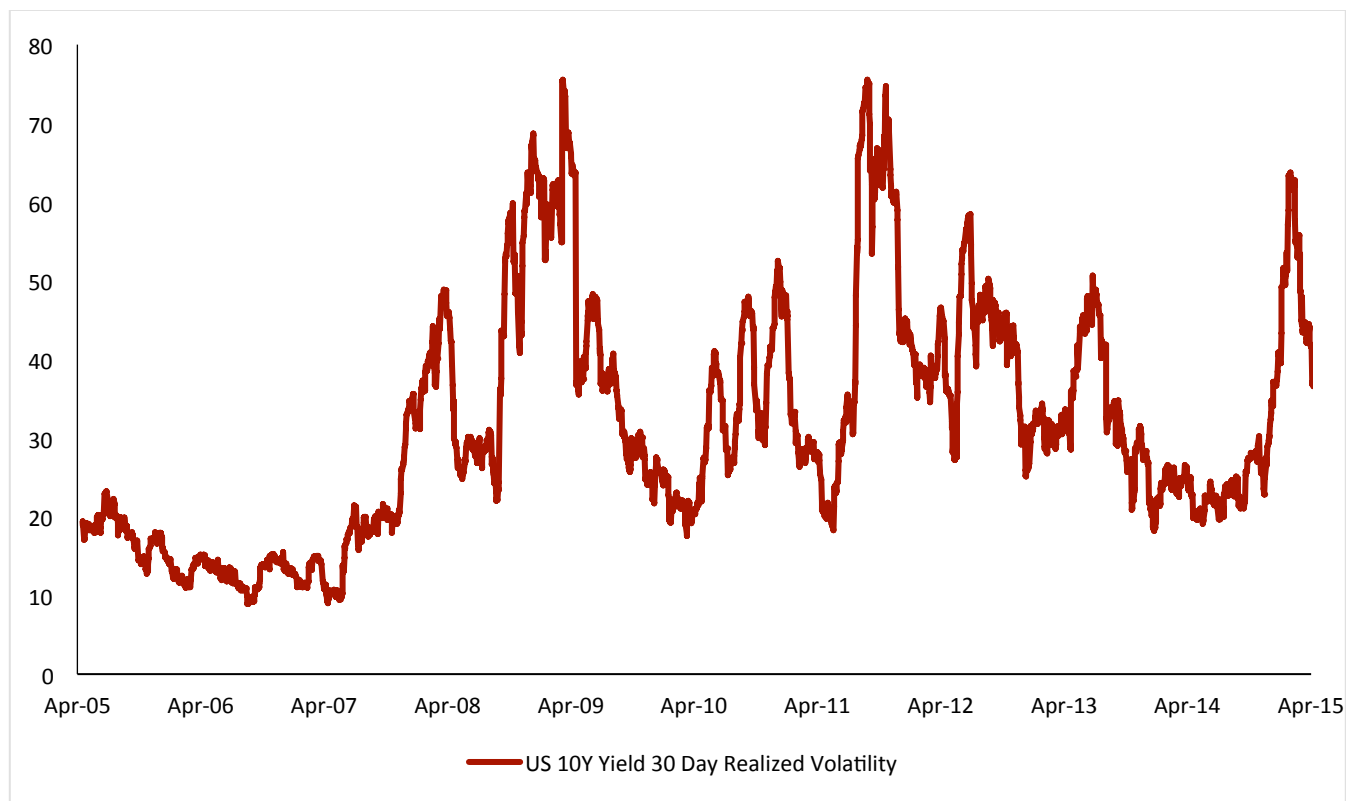


Figure 3: Canada Treasury Yield Curve

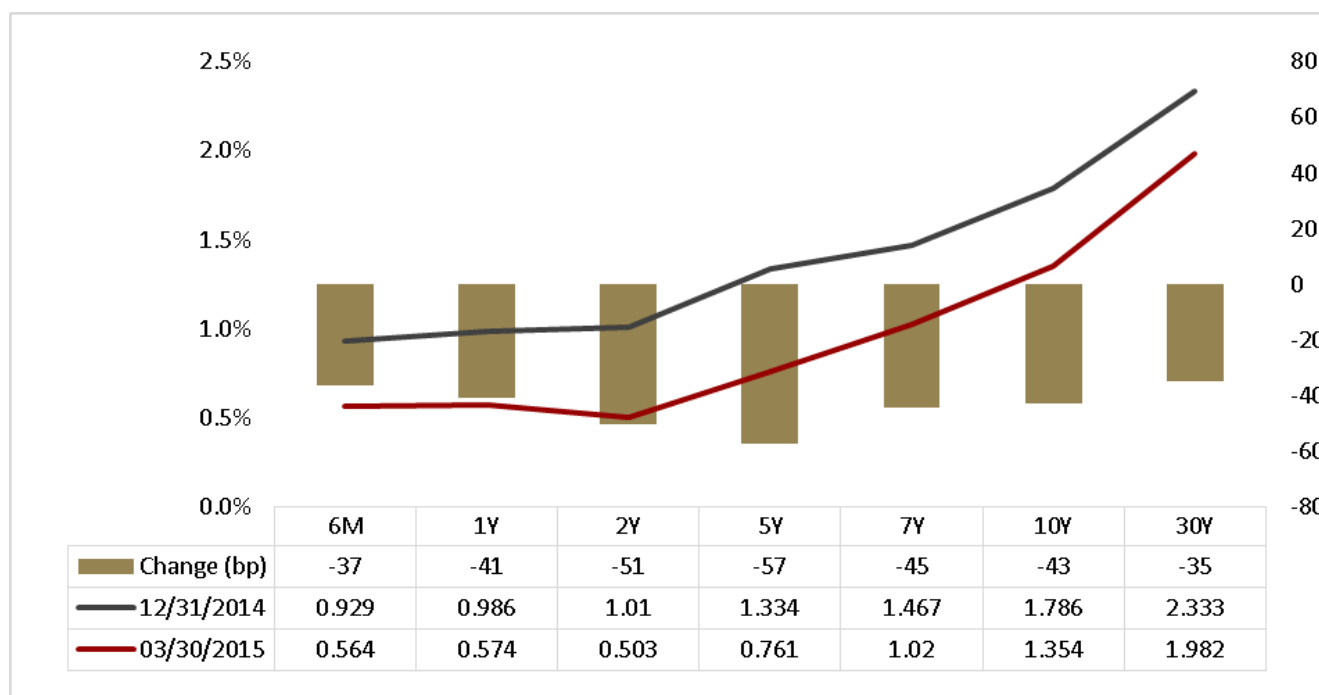


Figure 4: Global Central Bank Rate Cuts in 2015, as of March 31, 2015.

	Policy Rate	Current Rate	Last Change
<b>The Americas</b>			
Canada	O/N rate	0.75%	21 Jan 15 (-25bp)
Peru	Reference	3.25%	15 Jan 15 (-25bp)
<b>Europe/Africa</b>			
Hungary	2-wk dep	1.95%	24 Mar 15 (-15bp)
Israel	Base rate	0.10%	23 Feb 15 (-15bp)
Poland	7-day interv	1.50%	4 Mar 15 (-50bp)
Romania	Base rate	2.00%	31 Mar 15 (-25bp)
Russia	Key pol rate	14.00%	13 Mar 15 (-100bp)
Sweden	Repo rate	-0.25%	18 Mar 15 (-15bp)
Turkey	1-wk repo	7.50%	24 Feb 15 (-25bp)
<b>Asia/Pacific</b>			
Australia	Cash rate	2.25%	3 Feb 15 (-25bp)
China	1-yr working	5.35%	1 Mar 15 (-25bp)
India	Repo rate	7.50%	4 Mar 15 (-25bp)
Indonesia	BI rate	7.50%	17 Feb 15 (-25bp)
Korea	Base rate	1.75%	12 Mar 15 (-25bp)
Thailand	1-day repo	1.75%	11 Mar 15 (-25bp)

## Fixed Income Fund Holdings

Fixed Income Fund Holdings					As of end of Q1, 2015	
#	Security Name	Units	Purchase Price	Market Price	Market Value	% of total
1	ISHARES MBS ETF	550	\$106.74	\$139.75	\$76,860.09	15.8%
2	BMO LONG FEDERAL BOND INDEX	3,800	\$18.61	\$18.82	\$71,516.00	14.7%
3	US DOLLAR	46,278	\$1.14	\$1.27	\$58,610.86	12.0%
4	ISHARES 3 7 YEAR TREASURY BOND	300	\$125.39	\$157.26	\$47,178.39	9.7%
5	PROVINCE OF ALBERTA	400	\$99.54	\$106.35	\$42,540.34	8.7%
6	BANK OF AMERICA CORP	340	\$95.70	\$107.04	\$36,395.07	7.5%
7	TRANSCONTINENTAL INC	240	\$101.36	\$104.16	\$24,998.35	5.1%
8	HOME TRUST CO	240	\$102.31	\$103.84	\$24,921.44	5.1%
9	SPDR BARCLAYS HIGH YIELD BOND	500	\$39.40	\$49.67	\$24,836.06	5.1%
10	WISDOMTREE INDIAN RUPEE STRATE	886	\$23.95	\$27.03	\$23,951.63	4.9%
11	AIMIA INC	160	\$111.14	\$108.52	\$17,362.66	3.6%
12	CANADA HOUSING TRUST	130	\$111.43	\$114.94	\$14,941.99	3.1%
13	NEWALTA CORP	150	\$103.13	\$98.93	\$14,839.06	3.0%
14	RONA INC	140	\$103.75	\$103.21	\$14,449.58	3.0%
15	CANADIAN DOLLAR	(6,381.96)	\$1.00	\$1.00	\$(6,381.96)	(1.3)%
<b>Value of Cash &amp; Securities</b>					<b>\$487,019.56</b>	<b>100.0%</b>
<i>Top 5 holdings</i>					\$296,706	60.9%
<i>Top 10 holdings</i>					\$431,808	88.7%

*All figures in Canadian Dollars*

## Disclaimer

The Desautels Global Equity Fund and the Desautels Fixed Income Fund (hereafter: the Desautels Funds), together with Desautels Capital Management Inc., have been established as a pedagogical venture in order to offer students in the Investment Management Program in the Desautels Faculty of Management at McGill University some meaningful and realistic experience of the investment management industry and of investment research and analysis by working for Desautels Capital Management Inc. All outstanding shares of Desautels Capital Management Inc. are owned by McGill University. Desautels Capital Management Inc. has a separately constituted board of directors, all of whom are independent from McGill, and constitutes a separate legal entity having responsibility for its own affairs. The role of McGill University towards Desautels Capital Management Inc. is limited to the following activities: (i) appointing independent directors to Desautels Capital Management Inc.'s board of directors; and (ii) providing limited financial resources and support to Desautels Capital Management Inc., such as office space and allowing certain of its officers and employees to serve as officers of Desautels Capital Management Inc. or to carry out certain other functions.

Neither McGill University nor the Board of Governors of McGill University has the authority or power to act on behalf of Desautels Capital Management Inc. or the Desautels Funds, or to incur any expenditures on behalf of Desautels Capital Management Inc. or the Desautels Funds. Neither McGill University nor the Board of Governors of McGill University shall be liable for any debts or obligations of Desautels Capital Management Inc. or the Desautels Funds. McGill University is not involved in the daily activities of Desautels Capital Management Inc., including making investment decisions, and therefore does not take any responsibility for Desautels Capital Management Inc.'s activities. More specifically, McGill University has no liability under the Units, does not guarantee or otherwise stand behind the Units nor does it guarantee performance of the Desautels Funds. Any function or activity of Desautels Capital Management Inc. carried out by individuals who are also officers or employees of McGill University is carried out exclusively in the name of Desautels Capital Management Inc. and McGill University shall have no liability as a result thereof.

Neither the information nor any opinion expressed in this Report constitutes an offer or an invitation to make an offer, to buy or sell any securities or other financial instrument or any derivative related to such securities or instruments (e.g. options, futures, warrants, and contracts for differences). This Report is not intended to provide personal investment advice and it does not take into account the specific investment objectives, financial situation and the particular needs of any specific person. Investors should seek financial advice regarding the appropriateness of investing in financial instruments and implementing investment strategies discussed or recommended in this Annual Report and should understand that statements regarding future prospects may not be realized. Any decision to purchase or subscribe for securities in any offering must be based solely on existing public information on such security or the information in the prospectus or other offering document issued in connection with such offering, and not on this Report.

All opinions, projections and estimates constitute the judgment of the author as of the date of the Report and are subject to change without notice. Prices also are subject to change without notice. Desautels Capital Management Inc. is under no obligation to update this Report and readers should therefore assume that Desautels Capital Management Inc. will not update any fact, circumstance or opinion contained in this Report. Neither Desautels Capital Management Inc., nor any director, officer or employee of Desautels Capital Management Inc. accepts any liability whatsoever for any direct, indirect or consequential damages or losses arising from any use of this Report or its contents and, in some cases, investors may lose their entire principal investment. Past performance is not necessarily a guide to future performance. Levels and basis for taxation may change.

## Program Partners



**STATE STREET.**

