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Photo Credit:

Owen Egan

## Global Equity Strategy

**Dear Investor,**

For the month of November, Desautels Capital Management's Global Equity Fund returned -0.83% net of fees and expenses, bringing full year returns to 0.04%. Our benchmark, the MSCI World Index (\$C), returned 0.40% in November, and 8.66% year-to-date.

The fund's underperformance YTD can be attributed mainly to losses that materialized in the second half of the year in four of our holdings (Molycorp, Teva, Given Imaging and Nyrstar). We realize that when we buy stocks, we are not going to get everything right. We will have winners and we will have losers. When an investment does not go according to plan, we try to learn from our mistakes and correct them going forward. In light of the recent underperformance, we have implemented a new risk management process. For each holding, we continuously reevaluate whether or not the original investment thesis still holds. At the first sign of a stock's underperformance (when the stock declines by 10%), an automatic meeting is triggered between the analyst, the risk manager, and the equity strategist. Indeed, analysts are now facing much more scrutiny from fellow students when pitching a stock. We now spend as much time thinking about

what could go wrong as we do thinking about what could go right.

Since the semester started, we have balanced our portfolio with these thoughts in mind. We have strong convictions in our current holdings and believe we can deliver meaningful alpha over the long term.

### Portfolio Construction

With the addition of 12 new student-analysts this semester, we took a fresh look at our portfolio construction process. The equity fund is benchmarked against the MSCI world index, and our objective is to outperform the benchmark over a 4 year rolling time horizon. We can add value in one of two ways. First, through better sector allocation, meaning we underweight/overweight different sectors relative to their MSCI World Index weightings based on our macro view for those sectors. Second, we can try to add value through better individual stock selection within a given sector.

In the equity fund, we believe our competitive advantage is through the second method of better stock selection. We believe in deep fundamental research when conducting security selection. Recently



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# Global Equity Strategy

we have taken the decision to increase the concentration of our holdings, taking relatively larger positions in securities in which we have deep convictions. Being mindful of the benefits of diversification, however, we do not want to become overly concentrated. From a risk management perspective, we are comfortable with our current portfolio concentration.

## Portfolio Changes

### Einstein Noah Restaurant Group

Einstein Noah (BAGL) is a bagel specialty restaurant operator with 783 stores across 39 states in the US. Its banners include Einstein Bros. Bagels, Noah's New York Bagels, and Manhattan Bagel Brands. For us, Einstein Noah represents a special situation investment. Einstein Noah is majority owned by Greenlight Capital with a 63% interest. BAGL has a market capitalization of \$267 million. Since May, management had been exploring strategic alternatives to maximize shareholder value (Greenlight wants liquidity). On October 16, Management provided an update on the strategic alternative, which hinted at a dividend recapitalization of the company, which may include the payment of a \$9 special dividend on a stock trading around \$18. Following the announcement, the stock dropped from \$18 to \$15 and we viewed this as an attractive entry point. We like

the company as an investment for three reasons:

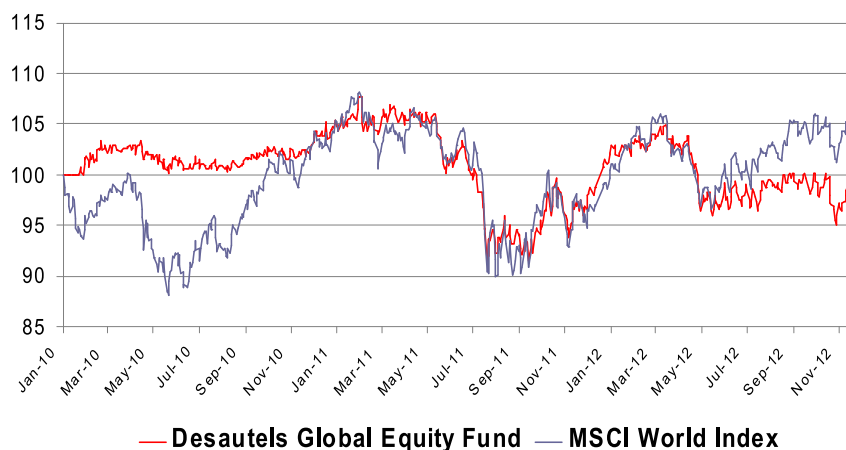
1. Illiquidity discount. BAGL only has \$94m in float currently, and this will be reduced to \$56m. However, illiquidity affects different fund sizes differently. As a small fund with sticky capital, we are okay with buying a few hundred shares while being compensated for taking on this illiquidity premium.

2. Operationally, the company is transforming from a capital intensive company-owned model to a low capital based franchise-model. What management is doing operationally complements the financial engineering on the liability/equity side of the balance sheet, as both strategies require a focus on higher cash flows as a major success factor.

3. The market is overly fearful of the execution surrounding the higher leverage of the pro forma company. Our stress test models, however, showed that the company would still be able to generate substantial cash flow, enough to safely service the newly added debt. Even under the most bearish scenarios, BAGL has limited downside risk, in our view.

We arrived at a price target of \$20 for BAGL by performing a dividend recapitalization model in which we assumed debt-to-EBITDA of 4.5x, interest on that debt of 6.75%, a special dividend of \$9, and an exit multiple of 8.0x EBITDA after 6 years. We initiated a position in BAGL at \$15.82.

## Global Equity Fund Performance Overview: as of November 30, 2012



Desautels Global Equity Fund		
	Fund	Benchmark
1 month	-0.83%	0.40%
3 month	-0.04%	3.53%
6 month	0.49%	7.38%
1 year	1.39%	8.25%
2 year	-3.09%	6.66%
YTD	0.04%	8.66%
Since Inception	-1.32%	5.31%

# Global Equity Strategy

## Whitecap Resources

Whitecap Resources is a light-oil focused development company based in Alberta. We believe the company is one of the strongest operators in the industry. Our investment thesis is threefold.

1.Lowest cost producer in the region from its strategy of developing reserves that are geographically clustered together. This strategy is attractive as the company is able to hire employees locally without subsistence pay. This gives them a cash netback of \$45/boe.

2.High growth in reserves on a per share basis – Reserve replacement ratio had grown by 450% and average reserve life increased to more than 14%.

3.Able and capable management – CEO Grant Fagerheim achieved high exit multiples for all three previous companies where he had been CEO. He is also the fifth largest shareholder of WCP.

Recently, Whitecap announced a quarterly dividend policy of \$0.60. We like this policy as it demonstrates that management is actively delivering cash flows back to shareholders, but also because it will allow for stable, sustainable growth for the future. We also support the dividend policy as we believe it will allow Whitecap to gain access to new investor base such as dividend income investors. DCM purchased Whitecap at \$8.36.

## Home Capital Group

Home Capital Group is a leading Canadian mortgage lender to the alt-A segment. We like Home Capital for three reasons:

1.Qualifying prime borrowers are now shifted down to Alt-A post the Flaherty rule. Big banks have tightened policies and scaled back loans to the self-employed. For Home Capital this means more volume (projected 8 % - 9% growth in 2013) with higher credit quality. Home Capital is best poised to capture the growth in the alt-A market.

2.Over-pessimism surrounding the overheating of the Canadian housing market. First, we note that the overheating is predominantly in the condominium

sector in large metropolitan cities. However, condominiums are less than 3% of Home Capital's loan portfolio. In addition, the average LTV on Home Capital's loan portfolio is 69.6%. This gives us confidence that Home Capital is protected from a significant decrease in Canadian housing prices.

3.Home Capital's due diligence in underwriting details, room by room walk through, independent appraisals and ongoing risk monitoring. This allows Home Capital to have low underperforming loans and low arrears. Their borrowers are not as risky as the market perceives them to be.

While Canadian banks trade at 10.6x 2012 earnings, Home Capital trades at 8.22x 2012 earnings. Using a dividend discount model approach, with 50% dividend payout ratio, an 11% discount rate and 3% terminal growth, we arrive at a \$64.35 price target. Even if the multiple does not expand, the EPS is growing at a 15% CAGR for the next 3 years, which is a rosier outlook than for other financials in the Canadian market. We bought Home Capital at \$52.77.

## Given Imaging

Given Imaging is a company based in Israel that develops, manufactures and markets diagnostic products for visualization of the gastrointestinal tract. Its flagship product, the PillCam, is a pill-sized capsule that is the recognized leader in capsule endoscopy. This represents a non-invasive way to monitor and diagnose GI tract disorders. We bought the stock in March at an average price of \$18.75. Our original thesis was that first, the Pillcam product reduces costs within the healthcare system as an outpatient procedure through higher diagnostic yield and earlier diagnosis of a number of disorders. This represents a significant growth opportunity in the coming years as insurers look for ways to cut costs. Second, wider acceptance of the PillCam in the diagnosis for Crohn's disease and obscure bleeding will also offer additional growth opportunity. And third, adoptance by the EMEA markets is likely as Given is expected to receive regulatory approval in late 2012. During the summer, there are a few headlines that prompted us to sell the



# Global Equity Strategy

stock. In July, Given announced that it will not submit the PillCam COLON 2 to the FDA for screening approval. The US market comprises an integral portion of Given's revenue and without the approval of key products, growth will not be realized. Q1 FY 2012 results also contained a few signs of weakness in growth as PillCam sales decreased in both Europe and Japan. We exited our position in Given at \$14.81.

## Sirona Dental Systems

Sirona Dental Systems develops, manufactures and markets dental equipment. It is the world leader in dental technology. We bought the stock in July at \$44.7. We were attracted to Sirona's high return on capital of 13.1%, a ratio that has been steadily growing over the last few years. We like Sirona's strong competitive advantage in the digital dental restoration and imaging space with its specialized line of product such as the CAD/CAM. In August, Sirona unveiled a new product in the imaging space called the Omnicam in the US, Europe and Australia. It provided significant benefits such as being powder free, streaming in full colour 3D, and being able to record both 2D and 3D data. Market reaction to the release is extremely positive, with the stock being up 20% since the release. While being positive on the Omnicam, we did note that Sirona will earn a lower margin on the Omnicam than previous models and it will take approximately 6 months to fill the global distribution channels. One of the competitors, Glidewell, has recently acquired IOS which provides a low cost alternative to the Omnicam at \$40,000 per machine. This represents a risk to Sirona, especially as we believe in a structural change in the healthcare industry to focus more on cost saving. We exited our position in Sirona at \$58.31.

## Teva Pharmaceuticals

Teva is a world leader generics manufacturer based in Israel. Its core generics business represents 1/5 of all US prescriptions and is 52% of Teva's revenue. Its branded division includes drugs such as Copaxone (treatment for MS) and company Cephalon, which has

exposures to oncology, pain and the central nervous system. We like Teva as they have continued to demonstrate cost leadership in the generics space through distribution and manufacturing advantages. Teva is one of three companies that can produce biosimilars and it is the first company to have a biosimilar (Neutroval) approved for sale in the US. This bodes well for Teva as the pharmaceutical industry undergoes the patent cliff. We also believe that the market is over-pessimistic on Copaxone's patent expiration, which won't happen until Sept 2015, as we believe there will be limited competition due to the complexity of manufacturing Copaxone. Thirdly, at current valuations the market is placing no value on Teva's pipeline, which has 40 drugs in phase III clinical trials. Teva's expertise in biosimilars also represents a growth opportunity as the next generation of generics. Based on the recent Copaxone ruling on June 24th, the courts may block generic version of Copaxone from entering the market until 2015 and this gives Teva time to develop their newer version. We added to our position in September to average our cost at \$49.61.

## TSO3

TSO3 is a Quebec based company that produces low temperature sterilizer for heat-sensitive medical devices. Its sterilizer, which is ozone and hydrogen peroxide based, is superior to all existing technology in terms of capacity, compatibility, cost and safety. The company is currently filing its device for FDA approval. The company had passed the 180 FDA days limit, and had to resubmit its document in April. At current prices, the market is pricing in a 45% - 55% probability of approval. However, we think that while the delay is unfortunate it shouldn't be interpreted a negative sign. First, TSO3 already sells its machine worldwide (outside of the US), with about 2250 sterilizers demanded annually. Second, given that TSO3 is a small company, it cannot finish its tests within the allotted 180 FDA days. The FDA is understaffed and TSO3 is possibly neglected as it is likely not a priority for the FDA. The market was also spooked by the

# Global Equity Strategy

company's termination of its agreement with 3M. However, we note that TSO3 exercised its right to terminate, and signed an agreement with Getinge right away. This should be interpreted positively as it shows there is confidence in the company's product and approval. We also like the partnership with Getinge more so than 3M, as Getinge is the global market leader in sterilization and disinfection. Getinge's partnership can pave the road for an eventual strategic acquisition that would allow for geographic expansion and access to new technology. We added to our position in TSO3 to an average cost per share of \$1.32.

## Bauer Performance Sports

Bauer Performance Sports is a Quebec based company that designs, develops, manufactures and markets sports equipment for hockey, lacrosse and its related apparel and accessories. The company was founded in 1927, sold to Nike in 1995 and later purchased by Kohlberg in 2008 and filed for IPO in 2011. Being the hockey nation, we recognize that Bauer is the market leader in hockey equipment. Despite the market perception of a stagnating hockey industry in Canada, we think Bauer will generate growth through its strategy of expanding into the lacrosse segment, which is growing by 10% annually, and through expanding into the apparel business which has higher margins. Additional upside includes the possible successful bid for the NHL contract, which Addidas currently holds. The recent acquisition of Cascades helmet reinforced our lacrosse thesis as Cascade represents 85% of the lacrosse helmet market, and offers a complimentary suite of products to Maverick (Bauer's lacrosse stick label). This places Bauer as the one stop shop for lacrosse equipment, which is growing at 10% annually. Despite its market leadership and growth opportunities, Bauer trades at a discount to its peers and to the consumer discretionary industry as a whole. We felt comfortable adding to our position in Bauer to arrive at an average cost per share of \$9.83.

## Fund Update

We welcomed 12 new junior student-analysts to the fund this semester. We started off the year officially with a bootcamp training retreat in the Laurentians in Quebec. But unofficially, our new analysts had already been preparing during the summer. Each junior is grouped into a different sector, in which they are mentored by a more experienced senior analyst. Again, we are reminded of your generous investment in the fund and your continuous support of the program.

Thank-you  
Ivan Di

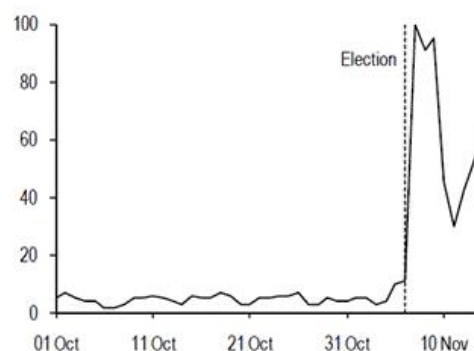
# Fixed Income Strategy

**While on Main Street the story of the presidential election is over, Wall Street is left with a cliffhanger...**

November was a volatile month as the U.S presidential election dominated headlines. An Obama victory was believed to be priced into the market as just prior to election day U.K bookies had 1-5 odds that the democrats would be successful. It was known weeks before that an Obama victory would be positive for the bond market and commodities and negative for the stock market. The after effect of presidential results is the biggest testament to the fact that markets are indeed inefficient. The Obama win sent equity markets plunging and bond markets rallying even though odds on an Obama victory were so high. One would expect the market to have already priced in the negative sentiment surrounding an Obama victory but this was not the case and the S&P 500 had one of its worst days of 2012.

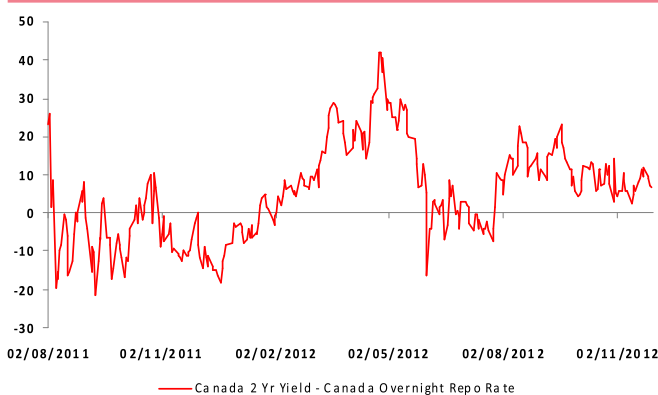
Post-election the markets switched focus from Obama vs. Romney to the impending fiscal cliff and subsequent American debt ceiling. The House of Representatives remains under the control of Republicans while the Senate and obviously the presidency under Democrat control. Markets are rightfully worried of a summer 2010 repeat with a stall in discussions and a sharp rise in volatility. Currently

**Figure 1: Public Interest in the Fiscal Cliff**



Source: JP Morgan and Google Trends

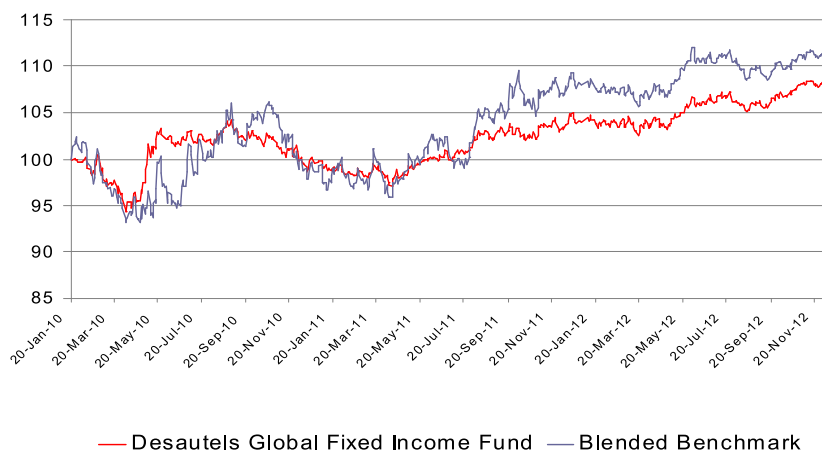
**Figure 2: Markets are pricing in a more dovish Bank of Canada**



Source: Bloomberg

investors appear to be on the fence as to whether Democrats and Republicans actually have it in them to come together and resolve these long avoided issues. The big question is can the Republicans and Democrats get along? With elections in the rear-view

## Fixed Income Fund Performance Overview: as of November 30, 2012



Desautels Fixed Income Fund		
	Fund	Benchmark
1 month	0.06%	0.04%
3 month	2.03%	1.40%
6 month	1.85%	0.19%
1 year	5.20%	4.29%
2 year	6.65%	10.44%
YTD	4.08%	3.11%
Since Inception	8.22%	11.36%

# Fixed Income Strategy

mirror and certain intolerance in the American population for another lame-duck congress, the most likely scenario is that a resolution is reached before the end of the year. History dictates that emotions do sometimes get the best of politicians although both sides seem to understand the implications of continually kicking the deficit can down the road and should ultimately reach a consensus.

While America has been at the center of headline risk this month, Greece also added to volatility as the country continues to struggle with their large debt burden and persistent budget deficit. Markets weren't sure whether or not Greece would be granted additional funds to cover debt coming due in the next couple of months and still worry that Greece is not committed to their deficit reduction plan. Greece is the annoying friend who shows up every once in a while and who nobody really likes but still talks to because it would be mean not to. Greece will be getting a \$56.8 billion bailout, which should keep the country alive for at least another year. Unemployment remains at 25% although the country has pledged to bring debt down from 190% to 124% of GDP which will probably not happen. Greece will continue to receive aid as the ECB is already too heavily invested to let the country fail. Over the coming year Greece will become less and less of an issue as the market gets used to the fact that the troika is only bluffing with their hesitation to grant Greece the aid it needs.

Mark Carney was recently announced to be leaving his role as the Governor of the Bank of Canada to join the Bank of England on July 1, 2013. The news was abrupt and surprising as this was the first time ever that a non-Briton was elected as the governor of the Bank of England. This will have implications for the Canadian bond market as has already been seen on the first day of the announcement. Yields rallied as Carney has been bias towards hawkish monetary policies over his tenure and thus the perception is that his successor will lean towards a more dovish monetary policy. Should we see this happen then it might be a good time to increase duration in the Canadian market. The impact in our view will most

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likely be mute as there is a large probability that Carney's successor continues with the same policies that helped make Canada's economy one of the most resilient over the past several years.

## Duration Overview...

We continue to remain short duration on the fund vs. our benchmark. Rates will most likely be range bound over the next year as opposing forces will be exerting themselves on investor confidence. On one hand we have the strengthening American economy with improving employment numbers and a reviving housing market. Inflation expectations are also believed to be underpriced on the long end of both the USD and CAD government curves. Desautels Capital Management is confident in remaining short duration with continued money printing around the world and the exponentially growing supply of money in the U.S along with a secular rise in commodity prices affecting Canadian inflation. That being said rates are anchored on the short end with a less than 10% chance of a rise in the fed funds rate currently being priced in as seen through fed funds futures. The Bank of Canada overnight rate is expected to remain at 1% through 2013 with a possible rate increase in early 2014. Due to this short term constraint on rates the fund has slightly increased duration by adding a 10 year Alberta provincial bond. Our current duration is 4 years vs. 5.6 for our blended benchmark.

## Credit View...

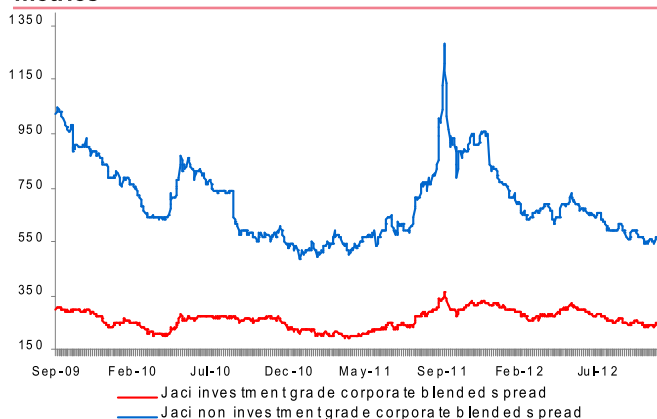
Spreads in both the high yield and investment grade sector have widened out slightly over the past month due to the volatility of the U.S presidential election, the upcoming fiscal cliff, and uncertainty in Greece. Drilling down into corporate fundamentals, a recent fixed income report from J.P. Morgan states that Q4 2012 is the first time since the 2008 financial crises where corporate credit metrics are deteriorating. Declining interest coverage ratio and free cash flow to debt, and increasing Debt to EBITDA are all worrying in the eyes of bond investors. The deterioration has mainly been due to declining EBITDA and increasing issuance of debt in the low interest rate environment. The question



# Fixed Income Strategy

is, what will drive spreads on corporate bonds over the coming year? Will it be the perceived strong fundamentals of these companies? In this case these new developments would make the fixed income fund decidedly bearish on credit. Or will it be the hunger for yield with government rates at such low levels? The fixed income fund believes spreads will be driven by both with the scale tipping in the favor of a hunger for yield in the current low interest rate environment which we expect to continue to play out over the coming year as government rates remain range bound. It is important to note that the hunger for yield has been artificially tightening spreads but this goes hand in hand with low rates which as previously stated we expect to trade within a range over the coming year. And thus, these new developments make the fixed income fund decidedly less bullish on credit spreads than in past months. Therefore, we will be focusing on security selection with a predisposition towards less risky credits. High Yield will be implicitly more driven by the hunger for yield over the coming year and therefore we plan on a continued near maximum allocation towards the sector but again with a focus on higher quality high yield credit.

**Figure 3: Credit Spreads not reflecting deteriorating metrics**



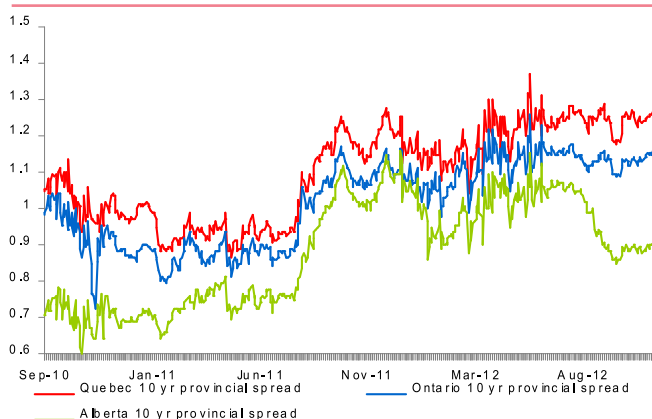
Source: Bloomberg

A significant portion of investment grade corporate exposure continues to be allocated towards financial institution maple bonds. Our Bank of America 2017, Morgan Stanley 2016 and Goldman Sachs 2022 bonds have all outperformed over the last months as liquidity eased in the interbank lending market and the euro threat was once again stifled. Spreads continue

to remain attractive, hovering around +300 bps, which in our view offers a great return for the amount of risk being taken. Our investment in the CI Investments 2016 bond performed well as the underlying positive drivers of the company continue to produce solid cash flows and above average coverage metrics. We will be looking to opportunistically exit the position as the bond approaches fair value and new opportunities arise in other areas with the secular down trend in non-bank mutual fund managers.

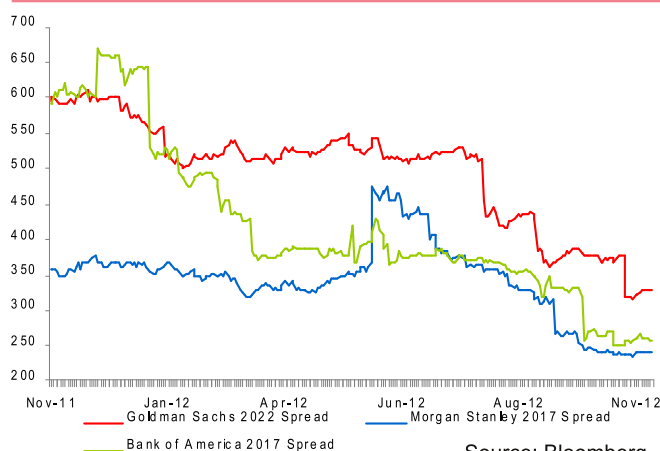
Provincial spreads are currently at attractive levels, trading at about +100 bps for both Ontario and Quebec 10 years. As stated in the duration overview above, the fund bought an Alberta 10 year bond back in late October trading at +76 bps over the curve. The bond has been close to spread neutral while allowing us to pick up positive carry over their Canadian government counterparts.

**Figure 4: Provincial Spreads trading at attractive levels**



Source: Bloomberg

**Figure 5: Financial Institution Bonds reaching fair value**



Source: Bloomberg



# Fixed Income Strategy

## Additions to the team...

This semester we had Rami Karabibar, Simon Bibeau, and Michaela Rachel joining our fund as new junior analysts, bringing a fresh and diverse perspective to the team. Seniors Simon Bouchard and Karolina Kosciolk will be working with the juniors to ensure an adequate transference of knowledge. The group is very enthusiastic and looks forward to the upcoming months of learning and alpha generation.

## View for the upcoming year...

Over the next year my goal as fixed income strategist is to outperform the benchmark while focusing on capital preservation. Along with this I aim to fully integrate junior students in to the fund and teach them extensively about bond valuation and rate analysis. I believe that the goal of every new strategist should be

to make the fund slightly better each year and improve the culture and procedures, allowing for new leaders to come in and build off of an already strong foundation. This program is truly a unique learning opportunity for my colleagues and me and I'm sure I speak for all of them when I say thank you for your continued support.

Thank-you  
Michael Comisso

# Top 15 Fund Holdings

The fund information below is accurate as of November 30, 2012

Global Equity Fund Holdings		Fixed Income Fund Holdings	
Security Name	%	Security Name	%
METRO INC	7.51%	ISHARES BARCLAYS MBS BOND FUND	14.04%
HOME CAPITAL GROUP INC	7.19%	ISHARES DEX HYBRID BOND INDEX	9.69%
ISHARES S+P GLOBAL MATERIALS S	6.98%	SPDR BARCLAYS HIGH YIELD BOND	9.60%
PULSE SEISMIC INC	6.83%	PROVINCE OF ALBERTA	9.57%
CAE INC	6.60%	BMO SHORT PROVINCIAL BOND INDE	9.34%
WHITECAP RESOURCES INC	6.00%	ISHARES BARCLAYS 3 7 YEAR TREA	8.78%
ISHARES S+P GLOBAL HEALTHCARE	5.88%	BANK OF AMERICA CORP	8.65%
WELLS FARGO + CO	5.79%	MORGAN STANLEY	7.55%
CONRAD INDUSTRIES INC	5.13%	CI INVESTMENTS INC	4.24%
BANK OF MONTREAL	5.02%	US DOLLAR	3.80%
EINSTEIN NOAH RESTAURANT GRO	4.92%	CANADIAN DOLLAR	3.66%
BAUER PERFORMANCE SPORTS LTD	4.92%	GOLDMAN SACHS GROUP INC	3.62%
TEVA PHARMACEUTICAL SP ADR	4.64%	CANADA HOUSING TRUST	3.52%
BCE INC	4.11%	WISDOMTREE DREYFUS BRAZILIAN R	3.08%
MICROSOFT CORP	4.01%	BMO LONG FEDERAL BOND INDEX ET	0.87%

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# Investment Team

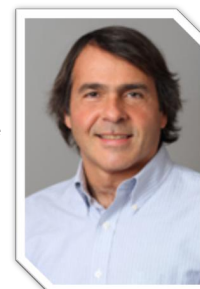
## A Message from the Chief Investment Officer

This world-class program now attracts some of the brightest and most talented students from around the world. I would like to take this chance to thank the many contributors who help make all this possible. On behalf of Desautels Capital Management, I would like to thank everyone for having confidence in us, and we look forward to another exciting new month!

Sincerely,

**Kenneth Lester**

Chief Investment Officer | Desautels Capital Management



Contact information for members of our investment team is available below:

Alan Ang	alan.ang@mail.mcgill.ca
Alan Vergeldedios	alan.vergeldedios@mail.mcgill.ca
Alejandro Cardot	alejandro.cardot@mail.mcgill.ca
Alexis Cardinal	alexis.lemieux-cardinal@mail.mcgill.ca
Ali Abdullah	ali.abdullah@mail.mcgill.ca
Andrew Macdonald	andrew.macdonald3@mail.mcgill.ca
Anna Wright	anna.wright@mail.mcgill.ca
Antonino Piazza	antonino.piazza@mail.mcgill.ca
Cedric Garnier-Landurie	cedric.garnier-landurie@mail.mcgill.ca
Emily Ren	emily.ren@mail.mcgill.ca
Fei Qi	fei.qi@mail.mcgill.ca
Ivan Di	minghui.di@mail.mcgill.ca
Jimmy Xie	jimmy.xie@mail.mcgill.ca
Karolina Kosciolk	karolina.kosciolk@mail.mcgill.ca
Mak Doric	mak.doric@mail.mcgill.ca
Megan Chen	megan.chen@mail.mcgill.ca
Michaela Rachel	ichaela.rachel@mail.mcgill.ca
Michael Comisso	michael.comisso@mail.mcgill.ca
Mohamad Awada	mohamad.awada@mail.mcgill.ca
Nicholas Bigelow	nicholas.bigelow@mail.mcgill.ca
Nicholas DiGiorgio	nicholas.digiorgio@mail.mcgill.ca
Noah Senecal-Junkeer	noah.senecal-junkeer@mail.mcgill.ca
Rafael Barroso	rafael.barroso@mail.mcgill.ca
Rami Karabibar	rami.karabibar@mail.mcgill.ca
Rene Boissonnault	rene.boissonnault@mail.mcgill.ca
Samantha Fu	samantha.fu@mail.mcgill.ca
Sanja Vcentijevic	sanja.vcentijevic@mail.mcgill.ca
Shawn Raza	shawn.raza@mail.mcgill.ca
Simon Bibeau	simon.bibeau@mail.mcgill.ca
Simon Bouchard	simon.bouchard@mail.mcgill.ca
Zeeshan Maqsood	zeeshan.maqsood@mail.mcgill.ca

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# Disclaimer and Disclosure

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.

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