



Qube Quarterly

2015: Q2



PRUNING FOR GROWTH

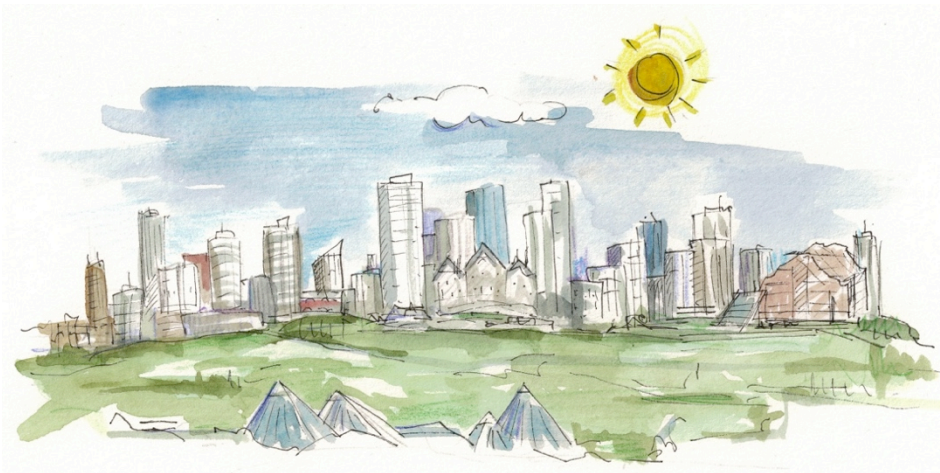
How do we manage the portfolio to ensure long-term growth? A little bit at a time...

In this issue

- 4 Greetings from the Editor
- 5 Portfolio Performance
- 6 Growth and Value: Two Sides of the Same Coin
- 10 Trades Under Review
- 17 Qube Insights: Kaleo Holdings
- 19 Qube Insights: Equity Research Snapshots







Qube Investment Management

Free of influence from bank, brokerage, and securities dealers, Qube is one of the few truly independent investment management firms in Western Canada.

Our only agenda is to take care of you while managing and expanding of your wealth.

We believe that when clients place their trust in portfolio managers, they deserve, in return, transparency. By publishing this quarterly activity report and engaging in personalized account reviews, we want to give you insight into how we think about investing and what we are doing with your investments.

Proper stewardship of your investments also means managing portfolio risk by incorporating responsible investing principles into all aspects of our work. Therefore we continue to act on your behalf to demand the best from management in the companies you own.

Much can be gained from tax and retirement modeling. We remain ready to assist all clients with planning services to ensure you minimize taxes and maximize your after-tax returns.

You work hard for your money – so we will, too.

Ian Quigley, MBA

Qube Investment Management Inc. is a registered portfolio management firm in the provinces of Alberta and British Columbia.

We are proud to serve you from our offices headquartered in Edmonton!



The year is half over and it's been an interesting one to be sure! Notably, worries about issues such as slowing growth in China and the Greek debt crisis are restraining the markets from surging ahead on the signs of a stable US recovery and a continued low interest rate environment.

What does this mean for your portfolio? In the long run, not a whole lot. Markets rise and fall, but the overall trend is upwards as economies adjust and eventually grow. Our job at Qube is to manage risk by keeping up the search for great companies that will endure over time, and recover quickly after any economic downturn.

Another way we manage risk is in our analysis of Kaleo's geographic exposure - where the companies we hold generate their revenues (see chart below for a comparison of Kaleo to industry standard global indexes). This gives us a two-fold advantage: gaining exposure to international markets without the costs of trading on international exchanges, and hedging currency risk. US companies figure prominently in the portfolio, for good reason. If the US dollar strengthens, we get the additional benefit of the currency tailwind. If it weakens, that's good for the companies we hold, as a weaker dollar bolsters international revenues, resulting in stronger balance sheets and more profitability over time.

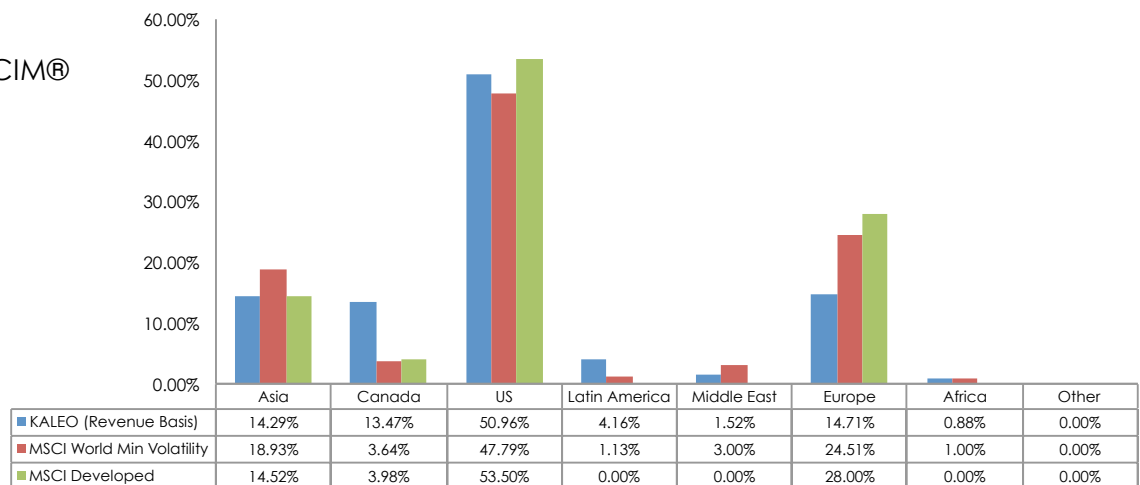
This quarter's theme is pruning for growth and our lead article talks about how we're looking ahead to be prepared for what the markets bring. We hope it's informative for you, and as always, get in touch with us if you have any questions!



Arden Tse, MBA CIM®



Geographic Revenue Breakdown - Kaleo Full



Greetings from the Editor

Contributing Writers:



Ian Quigley, MBA



Patrick Choi, B.Com



Colin Seto, B.Com

Congratulations to Colin Seto on graduating with his Bachelor of Commerce degree from the University of Alberta! He has been an integral part of the Qube team, and we wish him success in his future endeavors.



Kaleo: to call, summon, or invite...

Our invitation to you, to invest with us

At June 30, 2015

	YTD	2014	2013	2012	Since Inception (Jan 2011)
KALEO A	2.7%	20.7%	33.7%	12.2%	15.1%
KALEO B	3.9%	17.9%	33.4%	9.3%	14.1%
KALEO FULL	2.9%	22.0%	35.0%	12.6%	15.3%
S&P 500 (US Benchmark)	9.0%	24.0%	41.5%	13.5%	19.8%
S&P TSX (Canadian Benchmark)	0.4%	10.9%	12.7%	7.2%	4.7%
50% TSX / 50% S&P 500 (KALEO BENCHMARK)	4.7%	17.5%	27.1%	10.3%	12.2%

Kaleo is Qube's stock model, which is offered as follows:

Kaleo Full – currently a 43 stock + 2 index ETF model offered to clients with \$1M+ positions

For clients with positions between \$250,000 to \$1M, we offer two subsets of the Kaleo Full model:

Kaleo A – currently a 24 stock + 2 index ETF model

Kaleo B – currently a 24 stock + 2 index ETF model

Our model portfolios were launched in January of 2011. They continue to report a lower risk metric (beta) and generate a superior return when compared to our performance benchmark of 50% of the TSX (CAN) & 50% of

We currently aim to hold a stock for 3-5 years in our Kaleo models. This means we have an average portfolio turnover of 25%. In other words, a quarter of our positions change each year on average. One goal with Kaleo is to generate income through dividends. An investor entering Kaleo at inception would have a dividend yield today of over 3.5%. Many of the companies in our portfolio increase their dividends each year, so an investor can therefore grow his or her dividend over time. An investor entering Kaleo today would see a starting dividend yield of about 2.0%.

In the management of our Kaleo model, we use both company specific / fundamental analysis and macroeconomics to determine our positions (what to buy/sell).

Our research universe refreshes each year and we currently track between 150 and 200 companies. To learn more about our investment philosophy, please see our investing brochure at www.qubeconsulting.ca.

Also, please read our disclaimers on the back page of this newsletter.

Kaleo at a Glance

Patrick Choi
Ian Quigley, MBA



Growth and Value: Two Sides of the Same Coin

Arden Tse, MBA
Ian Quigley, MBA

What is a company worth? For long-term investors, the answer lies in a company's past, present, and future. The past and present are straightforward: financial statements measure revenue generation and the value of corporate assets. The future is a combination of potential earnings and earnings growth. Here is where opinions diverge. Many risk factors can affect a company's growth. Strategic plans, brand strength, and management are all internal factors that play a part, but how much? What about long-term external influences such as interest rates, demographics, currency fluctuations, and government policies? The type and sustainability of growth are also important considerations; not all growth adds long-term value to a company.

When examining the fundamentals of a company there are two predominant approaches investors use: growth investing and value investing. The two are related to each other by where they look for growth, but they typically perform differently from each other depending on what part of the economic cycle is in play. Most equity fund managers create portfolios using one philosophy or the other.

Paying for Potential (Growth Investing)

Imagine you're a billionaire business owner out shopping for a new sports team to add to your already massive portfolio. (We did say imagine...) After researching the teams available for purchase, you find one that has a star lineup. Every game sells out, and the team is on a winning streak that makes them a strong contender to go all the way and win the league championship. They're for sale, but at almost twice the price of what an average team is going for. Would you pay the premium?

This is a good analogy of what growth investors are looking for: star performance companies with significant winning potential at a premium price. These companies are often overvalued

compared to their peers, but investors believe they have all the right ingredients to grow their value more than other companies in that particular industry.

Growth-oriented companies can (but not always) do extremely well in an up market; they reinvest a large portion of their profits back into the company to grow the business, rather than pay out dividends. The payoff here comes in the form of a significant growth in the stock price.

An interesting thing to note is that steep up markets can also occur in the late stages of the economic cycle and, by the nature of market cycles, precede the inevitable downturn phase. These stocks may do well as they have a momentum effect and benefit greatly from the tail end of a rising market. Although they are affected by downturns, they can (though again, not always) recover quickly once the cycle picks up again.

Taking a quick look at data from Morningstar Inc. for total returns of US mutual funds from 2002 to 2011, growth funds (of all sizes) outperformed value funds and market indexes significantly in 2007 just before the start of the Great Recession, and in 2009 during the recovery:

Category/Index	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Large Growth	-27.64	28.66	7.81	6.71	7.05	13.35	-40.67	35.68	15.53	-2.46
Large Value	-18.69	28.44	12.97	5.95	18.15	1.42	-37.09	24.13	13.66	-0.75
S&P 500	-22.10	28.69	10.88	4.91	15.79	5.49	-37.00	26.46	15.06	2.11
Mid-cap Growth	-27.24	35.96	13.23	9.84	9.00	15.09	-43.77	39.11	24.61	-3.96
Mid-cap Value	-13.25	33.85	17.85	8.82	15.87	0.83	-36.77	35.41	21.92	-3.96
S&P Midcap 400	-14.53	35.62	16.48	12.56	10.32	7.98	-36.23	37.38	26.64	-1.73
Small-cap Growth	-27.88	45.54	12.41	6.02	10.81	7.59	-41.55	35.46	26.98	-3.55
Small-cap Value	-10.12	42.38	21.14	6.40	16.27	-6.08	-32.24	31.32	26.17	-4.45
Russell 2000	-20.48	47.25	18.33	4.55	18.37	-1.57	-33.79	27.17	26.86	-4.18

<http://mutualfunds.about.com/od/ValuevsGrowth/a/Value-Vs-Growth-Investing.htm>





Peter Lynch, a proponent of long term growth investing, ran Fidelity Investment's Magellan Fund from 1977 to 1990. The fund produced an average annual return of 29.2%,

almost doubling the S&P's annual return of 15.8%. Lynch pioneered the use of a combination of a company's current price, earnings, and historical growth to determine if it was worth buying. For Lynch, "The faster a firm is growing, the higher the P/E (price to earnings) multiple you should be willing to pay for its stock."

Shopping for a Bargain (Value Investing)

Who doesn't love a good sale? There's something inherently satisfying about knowing you got a steal of a deal. That's the heart of what value investing is: buying a stock that is priced below what its intrinsic market value should be – but what causes a stock to be undervalued?

It's important to understand that there are many measurements, calculations, and ratios that go into figuring out the value of a stock. When determining if the stock is trading at a discount or not, several measures can be used, such as:

- Price to earnings ratio (share price divided by earnings);
- Price to book value ratio (share price divided by reported assets);
- Dividend yield (dividends expected divided by share price).

Companies in the same industries will generally trade in similar multiples (e.g. Consumer Staples might all trade around 15 times earnings). When a stock is trading below its peers, this could be one indication that it is undervalued. Stocks can be undervalued for many reasons:

- Investors reacting to disappointing earnings, negative publicity, or legal issues;
- Assets within a company, with value not yet fully unlocked or acknowledged by the market (e.g. real estate, separate business lines, intellectual property);
- Macroeconomic factors that are affecting entire sectors, which have nothing to do with the fundamentals of how well the company operates.

The growth and payoff in these types of companies comes from the stock returning to its intrinsic market value over time, as well as in the dividends they pay. These companies often have good dividend yields due to the low valuation of their stock, and perform steadily in bearish markets.

Although he didn't call it value investing, the concept of looking for undervalued stocks was pioneered by Benjamin Graham and documented in his books *Security Analysis* (1934) and *The Intelligent Investor* (1949). Sifting through his work, Graham's investing philosophy can be boiled down to three principles:

1. **Margins of Safety:** As we've already discussed, this is the idea of buying a stock at a significant discount. The benefits are two-fold: the opportunity for return, and the mitigation of downside risk.
2. **Volatility is Your Friend:** Markets go up. Markets go down. This is an inevitable reality that all investors must accept. In times of market stress, intelligent investors don't hit the panic button; they look for opportunities to find bargains.
3. **Know Yourself:** There are many kinds of investors in the marketplace: passive, active, knowledgeable, naive. We can see speculators that are more akin to gamblers than investors, and folks who do the hard work of researching and understanding the companies they invest in. The point is to know what kind of market participant you are, and adjust your strategy and expectations accordingly.

Benjamin Graham quantified the metrics by which to value stocks using past reported data, essentially turning investing into a

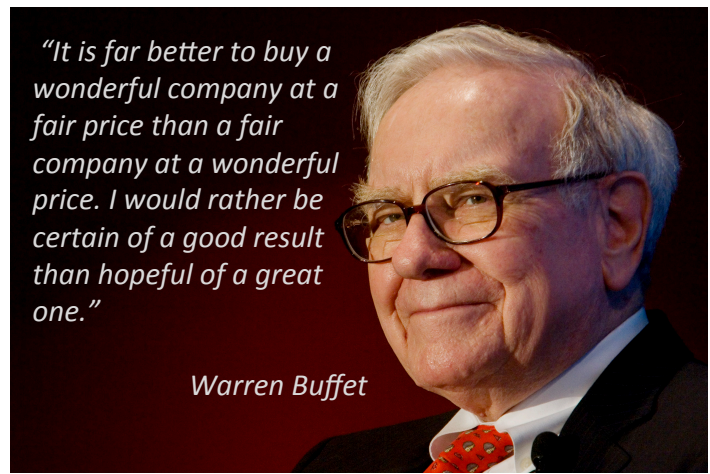


disciplined science. Prior to his work, investing was seen as a largely speculative activity.

One of Graham's most famous students, billionaire Warren Buffet, built his investment company Berkshire Hathaway's fortunes starting with a value investing approach. Buffet took Graham's principles and over time added and incorporated many principles of growth investing, such as taking a company's future earnings potential into account when seeking quality investments. In his 1992 letter to Berkshire Hathaway shareholders, he wrote, "The two approaches are joined at the hip: growth is always a component in the calculation of value, constituting a variable whose importance can range from negligible to enormous, and whose impact can be negative as well as positive." Buffet advocates for the incorporation of future growth rates into the analysis of intrinsic value and, simply, looking for quality companies with great potential, selling at a fair price. One could argue that growth investing is just a continuation of the theme of value investing; rather than waiting for a stock's value to catch up to the market, growth investors expect their stocks to significantly outperform the market.

Multiple studies have been conducted on funds using value investing techniques to see how they perform during various economic cycles. While the results are not consistently clear-cut, these funds traditionally tend to outperform market indexes in recessionary periods such as the late 1980s, and more recently 2002, and 2008. However, when the markets are bullish, they are significantly outperformed by growth stocks, as seen throughout the late 1990s during the bull run brought on by the technology sector.

At Qube, our Kaleo portfolio was initially built in the aftermath of the 2008 Financial Crisis when all the gains made since the tech bubble (early 2000s) were wiped out. The market recovery was sluggish, and there were a large number of fundamentally strong companies that were significantly undervalued. We built Kaleo on a foundation of "Deep Value Investing," as that was where the opportunities were to be found. Fast forward to the present day, where the markets have experienced a strong and steady rise. Many of the original companies in our Kaleo models have become fully valued and their growth trajectory has become somewhat muted.



Pruning for Growth

No matter what kind of investment philosophy one holds, all investors are trying to answer the same question: "What is going to provide me with the best return on my investment?" When the North American markets were underperforming, building a well-diversified portfolio of primarily North American value investments made sense, and this has paid off for Kaleo and our clients. Currently, developed markets continue to show a positive trajectory, and the US is poised for continued growth.

As an independent discretionary portfolio manager, Qube's philosophy has always been to invest in what makes sense, and maintain the discipline required for long term investing. History shows that no particular investment "style" wins in all scenarios, and global economic cycles are hard to predict. However, as investment professionals, we can design our portfolio to manage risk and be prepared for the scenarios that may occur.

We have set a goal to maintain 75-80% of the Kaleo model in value style picks, but will also continue blending growth-oriented stocks to better diversify and capture upside performance. This should allow us to take advantage of a prolonged growth cycle in the US, and, in addition, to weather any economic downturns through ownership of companies that we are confident can make a strong recovery.

If you look at the composition of the Kaleo portfolio, the companies that we've determined to be growth-oriented are solid industry leaders like Disney, Visa, Nordstrom, and Monster Beverage. In total, there are 8 growth holdings



out of 45, and we will be looking to add one or two more over time.

Continuing with the review of our portfolio holdings, we are researching three positions to replace this quarter:

- Sell Consolidated Edison -> Buy Citigroup
- Sell IGM Financial -> Replace with eBay
- Sell Proctor & Gamble -> Replace with Costco

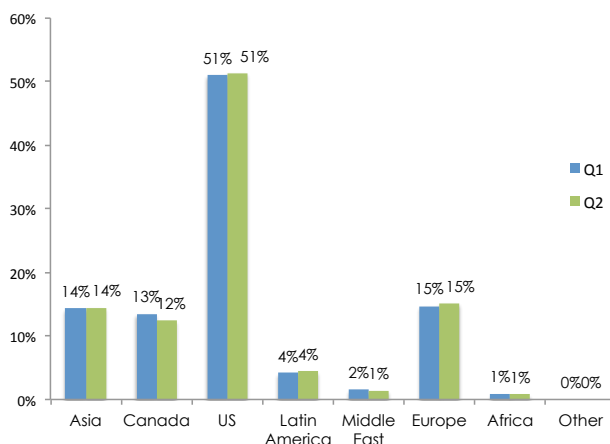
We are also attentively deliberate about the bigger picture composition of Kaleo in terms of macro level qualities such as sector and geographic exposure (as mentioned in the Greetings From the Editor). Comparing the portfolio composition from Q1 to include the trades we've been reviewing in Q2, you'll find that the portfolio characteristics do not change significantly.

As you read through the detailed trade analyses in the next section, you'll recognize some of the themes discussed here. We hope this gives you additional insight into how we think about investing.

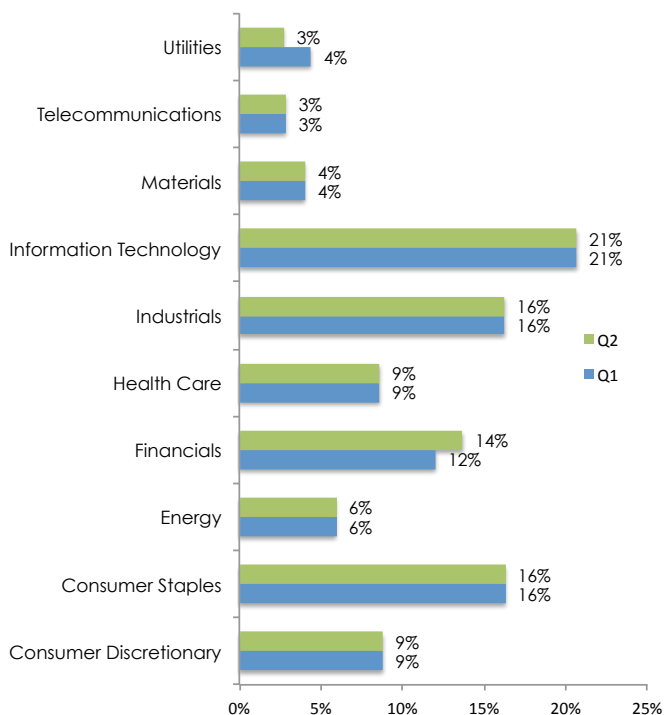
At the heart, our portfolio is about picking quality companies that our research indicates are fairly priced and poised to produce long term returns

above their market peers. Value and growth philosophies provide the tools used to help determine what companies exhibit these qualities. The benefits of long term investing are overwhelmingly positive, so we only prune approximately a fifth of the holdings per year, in order to hold the stocks for an average of five years each. We won't trade companies just for the sake of trading – there's nothing wrong with holding a great company for a very long time!

Kaleo: Geographic Exposure



Kaleo: Sector Exposure



Value investing looks for unrealized value that currently exists within a company to eventually be recognized by the markets.

Growth investing looks for value to be created by the company and subsequently be rewarded by the markets.



TRADES UNDER REVIEW



Buy C
Sell ED

The Price is
Right!
(The Plan is,
too...)

Patrick Choi
Arden Tse

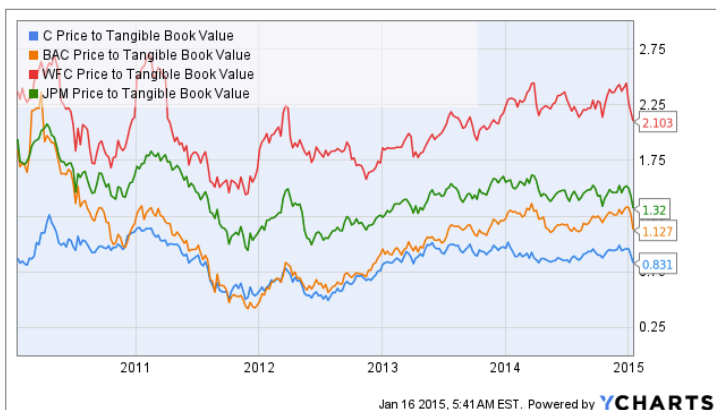


PHOTO: STEPHEN HILGER/BLOOMBERG NEWS /LANDOV

Out of the 4 largest banks in the United States, Bank of America and Citigroup are perhaps the 2 most reviled following the 2008 subprime mortgage crisis. This is not surprising given that each of these banks received the largest amounts of US taxpayer money (\$45B each) from the very unpopular TARP (Troubled Asset Relief Program). Citigroup has the added distinction of nearly going out of business when its shares briefly traded below \$1. When it comes to the term "Too Big To Fail", both Citigroup and Bank of America are probably the two institutions that come most readily to mind.

Why Citigroup?

Our 'buy' thesis on Citigroup hinges on a single point: low valuations. Seven years after the financial crisis, the distrust the markets had for Citigroup in 2008 continues into 2015. This discount compared to peers is most easily shown through a comparison of Price to Tangible Book Value (arguably one of the most relevant metrics for banks, as the vast majority of their assets and liabilities deal with money). Citigroup's P/TBV is currently trading at below 1; theoretically, shareholders can make a profit by just liquidating the bank assets and paying back all liabilities, and is the lowest of the 4 major US banks.



From the accompanying graph, astute investors may have noticed that low valuations for Citigroup are nothing new, and so would rightfully ask the question, "What's different this time?" We believe that there are 5 factors converging, potentially making this time distinct, and contributing positively to Citigroup's valuations going forward:

1) **Getting Lean:** Citigroup continues to cut costs by closing offices, selling subsidiaries,

(continued)



and downsizing their work force to become a leaner and more efficient company. Legal expenses are decreasing year over year, and with each new settlement, legal liability clouds will continue to clear. These two factors should help Citigroup expand their P/TBV multiple going forward through the increase in their earnings per share.

2) Reducing Risk: Along with reducing their global footprint, Citigroup is also working to reduce risk to their lending portfolio, jettisoning their subprime mortgage business while at the same time offsetting the loss with higher quality loans. One example is Citigroup's deal to service Costco's consumer credit business. Costco's business will grant Citigroup credit relationships to higher net worth and more diverse clients, compared to their subprime mortgage counterparts. There should be substantial upside for Citigroup in this deal if they also expand this relationship further by offering Costco Members special deals on savings and checking accounts and/or mortgages.

3) Passing Grades: 2015 marks the first year that Citigroup has passed the Federal Reserve's Comprehensive Capital Analysis and Review (CCAR), a regulatory framework that assesses whether banks possess adequate capital given various stress-test scenarios; depending on how well the companies perform, this will also dictate the amount of capital distributions (dividends & share repurchases) allowed for the year. The failure to pass CCAR, until recently, was one of the reasons why Citigroup's share price had recovered the least when compared to their peers.



We expect Citigroup to continue to pass and exceed CCAR requirements on the back of higher interest rates, continued growth in the US economy, and lower operating and legal costs. These factors should help Citigroup expand their shareholder distributions program, which in turn should help boost its valuations relative to peers.

4) Rising Rates: Given the strength of the US economy relative to peers, the rise in US interest rates is more likely a matter of "when" rather than "if." When interest rates do rise, we expect banks like Citigroup to be able to profit from the move, as they become less squeezed by the interest margin contraction from the last several years. Rising interest rates is also the reason why we propose selling Consolidated Edison. While we believe this company to be one of the best-run utility companies in the United States, with safe revenue streams and high dividend yields, that alone cannot turn the incoming tide of higher future interest rates. As interest rates rise, companies that rely on dividends for a large portion of total shareholder returns (utilities) will most likely see share prices fall as investors substitute bond-like stocks for actual bonds.

5) Improving Metrics: From their latest quarterly financial statements, there were several metrics in particular that give us confidence in Citigroup's turnaround efforts. The first metric is earnings; Citigroup announced the highest earnings in 8 years, due to success in their cost-cutting measures and lower legal expenses. Secondly, Citigroup's efficiency ratio (an important banking metric that shows the amount of overhead required to generate revenue – the lower the ratio the better, with 50% considered the maximum optimal ratio) has been improving and is currently sitting at 56%, lower than both Bank of America and JP Morgan Chase, who the market currently values at a greater premium.

Given our belief that US interest rates are set to rise in the near future, we feel that now is the time to sell Consolidated Edison for Citigroup. With Citigroup, investors not only benefit from a higher interest rate, but can also invest in an undervalued company (rare these days) with multiple tailwinds to success. In the coming weeks, we will be looking for the most opportune time to finalize our trade.



TRADES UNDER REVIEW



P&G
Procter & Gamble

Buy COST Sell PG

This quarter we looked at our consumer discretionary portfolio and, in general, were quite content with it. Lower oil prices and increased consumer confidence have led many companies to post better than expected revenues and profits. Although the strong US dollar caused significant headwinds, on a constant-currency basis, many of them did quite well.

Procter & Gamble, however, is an exception. This leader in consumer products has struggled to remain competitive relative to its peers in recent years. While it has provided a strong return of cash (through dividends and share-buybacks), in our view, it will take years before Procter & Gamble can revert back to its former position as an industry leader.

Instead of taking the risk and waiting for things to get better, we have decided to switch out P&G for Costco, another leading consumer discretionary company that we believe is more nimble, more focused and better suited to face the challenges of the ultra-competitive retail environment.

Procter & Gamble is a global leader playing catch up. Without a doubt, P&G has had a long history of success. Their products are sold in over 180 countries and include ubiquitous brands such as Pampers, Tide, Pantene, Charmin, Crest and Gillette, all of which command sizable market share in their respective areas.

Focused Growth

Colin Seto
Arden Tse

However, P&G has not lived up to investor expectations in recent years: challenges in P&G's Personal Care and Beauty business, their slow entry into emerging markets and a constant emphasis on "premiumization" of products have all led to market share lost, prompting the exit of CEO Bob McDonald, and the return of former CEO A.G. Lafley in May of 2013.

Realizing the need to reduce expenses and raise productivity, Lafley accelerated the \$10B restructuring program, with the goal of strengthening core categories such as baby and fabric care and divesting brands, such as Iams and Duracell, that are deemed to be not within the core portfolio. A total of 100 brands will be shed, representing about 15% of sales and 5% of profits, leaving a core portfolio of about 65 brands. As of this year, 40 brands have already been divested, with an estimated completion by fiscal year 2017.¹

Portfolio Plan Multi-Year Journey



Business Exits	Sales
Coffee	\$1.6
Pharmaceuticals	\$2.3
Water Purification	\$0.1
Snacks	\$1.5
Kitchen Appliances	\$0.3
Bleach	\$0.2
MDVIP	\$0.2
Pet Care	\$1.5
Batteries	\$2.3

~\$10bn
Annual
Sales

Market Realist[®]

Source: Procter & Gamble

(continued)



Significant strategies take time to unfold and prove their success. However, we are not keen on waiting, as we believe that P&G has lost focus on what really drives growth: innovation and productivity. With so much focus on operational improvement and restructuring, this has become part of the cause instead of part of the cure, and not the solution to the company's stagnant top-line growth. We agree that the strategy of "growing by shrinking," selling weak assets, and focusing on the strength of surviving brands is viable in some circumstances. For a company like P&G, however, whose growth in organic sales is only 1-2% per year, it is a quite disappointing strategy. *(As of this writing, it appears that Lafley will be stepping down this summer (2015) to be replaced by an internal successor, bringing in even more uncertainty to the direction of P&G).*

Costco, on the other hand, is a force to be reckoned with. Costco's membership-based wholesale model effectively allows the wholesaler to become the retailer itself; members are offered low prices on a wide range of merchandises in an effort to provide high sales volume and rapid inventory turnover. These self-service warehouse facilities allow Costco to operate at significantly lower margins than peers while providing high quality products. In contrast to P&G, Costco has a clear focus on growth.

Investing in organics selection. The organic food market is expected to grow at double digits until 2018 due to growing domestic production and increased awareness. Costco is already the third largest organic retailer in the US (next to Whole Foods and Trader Joes) with the potential to become the largest, given its lower pricing (40% less than peers). Organics generated sales of \$3 billion last year and is up 50% Y/Y.²

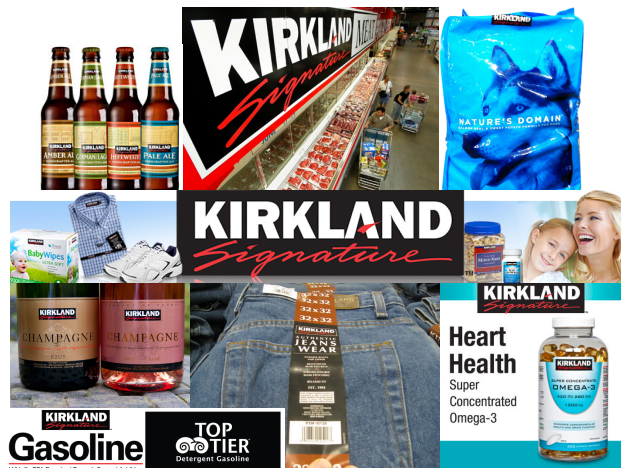
Expanding internationally. Out of 34 warehouses that are expected to open this year, 14 will be outside of the US. We expect Costco to continue to focus on ramping its international expansion, given lack of direct competitors and higher operating margins (4.4% in Canada versus 2.3% in the US).

¹ P&G Earnings Transcripts

² Costco Earnings Transcripts

Focus on Kirkland Signature Brand. Costco's signature brand provides immense value to shoppers; it prides itself on being equal or superior to national brands. In most cases, the house brand is produced at the same location the premium brand and is made by the direct competitor! Roughly 20% of Costco's SKUs are Kirkland branded and management is keen on bringing in more.

All of these growth strategies are cleverly



funded by Costco's membership-based fee, (annual income stream is ~ \$2.4B), expected to grow at high single digits. The strength of Costco's strategy and flawless execution is clearly evident. By focusing on passing savings on to members, members are incentivized to shop at Costco, which grows the company's top and bottom lines. In addition, American Express was dropped as their credit card provider, and Visa and Citi have signed on as the new providers in the US, adding improved convenience to members and, of course, savings. (The interchange rate is expected to be 0.4%, one fifth of what Visa usually charges other providers).

In summary, we feel that P&G has lost its sense of direction and focus in recent years due to internal structural changes. Switching it for Costco, a more nimble and well-executed company that has strong growth potential (yet exhibits the characteristics of a blue-chip company - low beta, strong dividend yields and share-buybacks), would bode well for the KALEO portfolio going forward.



TRADES UNDER REVIEW



IGM
Financial™

Trading Up for Growth

Patrick Choi
Arden Tse

Buy EBAY Sell IGM

IGM Financial is a Canadian mutual fund company with \$142B in assets under management. Their two main divisions are the Mackenzie group of funds and Investors Group, controlling approximately half of the AUM each. Investors Group has an army of 5,000 financial consultants that offer mortgages, insurance and investments to their clients; on the Mackenzie side, solutions are offered through high fee mutual funds.

eBay Inc. is a multinational corporation currently composed of 2 distinct entities: eBay Marketplace (e-commerce) and PayPal (an online payments system). On a revenue basis, the two entities are approximately equal. It was recently announced that eBay's board has officially approved the breakup of PayPal and eBay, with shares of PayPal to be distributed to eBay shareholders on Friday, July 17.

Out with the Old

Due to a recent drop in share price, IGM currently has a dividend yield of 5.5% on a 70% payout ratio (ie: 70% of earnings are paid out as dividends). While the yield looks impressive at first glance, we believe there are two major points that could make IGM a classic value trap.

- 1) IGM's share structure is very hostile to activists or any other investors looking to institute change in the company to create value. The reason? Power Financial, the holding company whose controlling shareholder is the Desmarais Family, currently holds a controlling stake of 58.6% of IGM. Given the lack of external pressure, it is possible that any turnaround for IGM may occur slower than what our patience would allow.
- 2) The larger problem for IGM is their business model (Investor's Group, and to a lesser extent, Mackenzie Investments), centered on managed funds with high fees, which we believe are unsustainable. There will be less tolerance for high fee solutions due to increased investor sophistication and the growing popularity of lower fee solutions like ETFs, which provide investors with many more lower cost options than ever before. Added to IGM's problems are Canadian regulators who have mandated the implementation of CRM2 (Customer Relationship Management Phase 2) later this year, requiring more transparency in fee reporting, as well as contemplation of banning the use of trailer fees as a form of compensation. CRM2 makes IGM's higher fees become much more transparent, and could potentially lead to an erosion of its client base. In addition, losing trailer fees as a form of compensation could potentially wipe out a large portion of IGM's sales force as consultants quit in favor of finding better compensation elsewhere. By and large, this is an unpleasant scenario for IGM.

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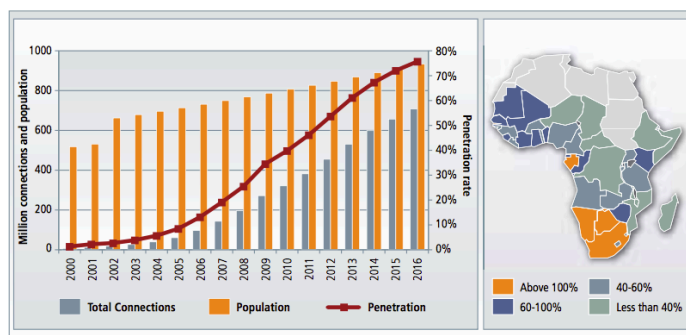


In with the New

Our sole driver for purchasing eBay is for the ownership of PayPal. There are four factors that could make PayPal a compelling investment going forward:

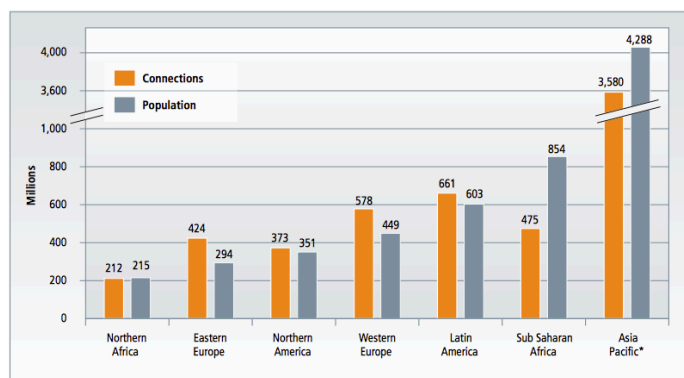
- 1) PayPal has been an incredible growth story since the early 2000s when it was acquired by eBay for \$1.5B. Today, PayPal's annual revenue alone is more than 5 times the initial purchase price. In our view, mobile and online payment usage is still in its infancy. As consumers become more comfortable with the technology and increase their adoption of mobile/online payments over time, and the volume of online market place transactions grows, we believe that PayPal, with their strong brand image and leading positions, can continue to post solid growth rates in the future.
- 2) There is substantial room for PayPal to grow mobile payments internationally. We are all familiar with the growth in mobile for the Asia-Pacific region, but the greatest potential of all may perhaps be found in the most unlikely of places: Africa (sub-Saharan Africa to be precise). The region that encompasses sub-Saharan Africa (SSA) has a combined population of about 850 million people, with about 50% of that aged 19 or younger. The young demographics may have already contributed to the reason why SSA, despite the low average GDP/Capita in the region, had approximately 475 million mobile connections in 2012. This number would only have grown since then, seeing as the compounded annual growth rate from 2000-2012 in the region was 44%, the highest in the world.

Figure 1: Mobile connections, population and penetration in SSA since 2000; and map of mobile penetration, 2012



Source: Wireless Intelligence

Figure 5: Population and connections



Source: Wireless Intelligence. *Asia Pacific bars rebased to fit axis range.

By combining Africa's growth in mobile with the fact that most Africans do not have access to banking services, PayPal's recent expansion in this area could theoretically translate into half a billion more users by providing access to cheap banking through their mobile phones.

Banking on the Go

Mobile financial services are popular in Africa, where many have mobile phones and few have traditional bank accounts.

Region	Mobile financial accounts per 100,000 adults, June 2013
Sub-Saharan Africa	24,652
Middle East & North Africa	15,164
World average	4,361
South Asia	3,485
Latin America, Caribbean	2,165
East Asia, Pacific	1,657
Europe & Central Asia	416

Source: Groupe Speciale Mobile Association, World Bank

The Wall Street Journal

- 3) PayPal, as a separate entity, could be an interesting target for an acquisition. One potential acquirer is Facebook, who hired away PayPal's president David Marcus in 2014. An acquisition of PayPal would give Facebook an already built and running payment platform, which is one of the directions where Mark Zuckerberg would like to take Facebook, judging from the poaching of David Marcus and the recently added money transfer ability through Facebook's messenger service. Other potential acquirers with their own reasons for owning a payment service include Alibaba, Google, MasterCard, Visa, American Express and Apple.



- 4) Due to the rapid acceptance of mobile and online payment systems, and its incredible brand recognition, PayPal has the opportunity to not only address the \$2.5 trillion market in online and mobile finance, but also to expand into the \$25 trillion market associated with general commerce, both online and offline. This is exactly what the CEO of PayPal, Dan Schulman, highlighted during their most recent conference call. One such opportunity highlighted was loan origination. Currently, PayPal is not just a transactions platform, but is also a lender to small businesses. As an extension, they could also expand their loan origination to include medium sized businesses, re-package, and then sell them to third-party investors. With PayPal's large global footprint with merchants and consumers, the company's credit originations could potentially grow into a large business.

Weighing the pros and cons between IGM Financial and eBay (PayPal), we feel that now is the time to sell the former and acquire the latter. With PayPal, there are a multitude of potentially positive developments that could help generate positive returns, including the mobile and banking revolution currently happening in sub-Saharan Africa and around the world. In the coming weeks, we will be looking for the most opportune time to finalize our trade.

"Following the 2008 financial crisis, banks severely restricted access to capital, disproportionately affecting fledgling and medium-sized businesses. Annual loan originations to businesses ...fell dramatically between 2007 and 2013. For ... PayPal this created an opportunity. They are now offering loans and advances to their small-business clients and charging a fixed fee for the capital advance. It's a way to develop a new revenue stream and help their merchants grow (which in turn, means more money from credit card transaction fees). "

*John Heggestuen – Business Insider
"Payments-tech companies like PayPal and Square are moving aggressively into lending and disrupting banks". July 2, 2015*



QUBE INSIGHTS: Kaleo Holdings

Patrick Choi
Arden Tse

Every quarter we will highlight some of the portfolio holdings and share with you our investment thesis (why we hold the stock) plus examples of news and activities we're seeing in the market that support or contradict that thesis. We'd like to give you some insight into our thought processes so you can understand why we hold or want to sell these companies.



Kaleo Full, B

UPS is one of the largest shipment and logistics company in the world, delivering more than 15 million packages a day to more than 6 million customers in 220 countries around the world. It has been said that there is no certainty in investments; however, if we did need to bet on one thing going forward, it would be in the growth of online transactions and the erosion of the brick and mortar model. This has been true since Amazon first opened their digital doors, and we believe it will continue to be true going forward given the inherent and substantial cost advantages. One of the beneficiaries of this long-term, secular trend going forward is UPS.

"E-commerce retail sales in the U.K., Germany, France, Sweden, the Netherlands, Italy, Poland and Spain are expected to grow more than 40% over two years to £185.44 billion (\$289.60 billion) in 2016..."

(Laura Stevens, The Wall Street Journal, July 1, 2015)
UPS, FedEx Move Full Speed Ahead in Europe



Kaleo Full, B

INTEL – Our initial purchase of Intel at \$21.08 was a contrarian play. While everybody else was looking at the rise in mobile and the death of computers (laptops and desktops), we saw the continued need for productive computing, the growth in servers due to Cloud, and the extraordinary competitive advantage that Intel has gained over its competitors in silicon manufacturing. We believe these tailwinds for Intel will continue for the near future. Some of the key events to keep track of would be the rollout of Windows 10, the continued success of 2-in-1 laptops, the continued growth in servers, the success of the internet-of-things market, and their continued lead in their manufacturing process.

"One of the most impressive stories going on at Intel today involves the company's data center group. Last year, this business grew 18.2% to just shy of \$14.4 billion in revenue, and it delivered a cool \$7.39 billion in operating profit. Intel is even forecasting that it will grow revenue in this business by over 15% this year, with operating profit outgrowing revenue growth."

(Ashraf Eassa, The Motley Fool, June 8, 2015)
<http://www.fool.com/investing/general/2015/06/08/intel-corporations-data-center-group-has-room-to-g.aspx>

(continued)





Kaleo Full, A

Western Digital is one of the largest digital storage (hard disk drive - HDD) manufacturers in the world. Along with Seagate, they have a near global duopoly in the HDD space, with Western Digital commanding 44% of the global market share. Going forward, the secular trend that will benefit Western Digital the most is the growth in Cloud computing and big data analytics. They have addressed the headwinds of Solid State Drives (SSDs) through smart acquisitions, but we also believe the lower price point, and ongoing innovation in performance and energy efficiency, will have enterprises continue to favor HDDs. Either way, the company looks ready to maneuver with the markets.

"HDD is a stable product. It's tried, tested and reliable. And following the emergence of SSD, the cost per gigabyte ratio will always favour the spinning disk, at least for the next five years." Charlie Hacker, Director of Business Development, M2m

(Dominic Sacco, PCR, July 2, 2015)

<http://www.pcr-online.biz/news/read/interview-why-m2m-direct-plans-to-enter-the-enterprise-market/036489>

"Western Digital Corp (WDC) declared the first enterprise-class 10TB (terabyte) hard disk drive (HDD) for next-generation active archive applications. The host-managed Ultrastar Archive Ha10 SMR HDD sets a new standard in enabling the world's densest server and storage systems with unprecedented TCO levels."

(Sheila Burnford, WS News Publishers, June 15, 2015)

<http://www.wsnewspublishers.com/pre-market-news-report-on-western-digital-nasdaqwdc-prima-biomed-nasdaqpbmd-hawaiian-holdings-nasdaqha-deutsche-bank-nysedb/1511266/>

NORDSTROM

Kaleo Full, A

Nordstrom is a fashion retailer that services both the upscale market with their full-line stores and the more value conscious market with their Nordstrom Rack outlets. Unlike most traditional retailers, Nordstrom has been effective in transforming their business from brick-and-mortar retailing to an omni-channel model where the company connects with customers through all available means: mobile, brick-and-mortar, social media, and e-commerce. Nordstrom's transformation in their retail business model has already paid handsome dividends through consistently growing sales, and we believe this trend will continue as they innovate and build even deeper relationships with customers.

"In recent years, Nordstrom has outperformed its peers in the department store category. This has mainly been possible due to the company's off-price Nordstrom Rack stores and its online channel...Nordstrom is heavily investing in technology to enhance consumers' shopping experiences and further boost growth in online sales. Nordstrom also believes that Canada represents a \$1.0 billion opportunity for the company in the long term."

(Sharon Bailey, Market Realist, June 25, 2015)

<http://marketrealist.com/2015/06/nordstrom-highlights-growth-strategy-june-consumer-conference/>



QUBE INSIGHTS: Equity Research Snapshots

Patrick Choi
Colin Seto
Arden Tse

Our equity research is guided by a proven value-based approach pioneered by Benjamin Graham. Balancing traditional research techniques with modern portfolio science allows our team to find companies that demonstrate and maintain solid investing fundamentals. We look for less volatile and proven earnings combined with long-standing stable dividend policies. Share prices need to be justified on a combination of current earnings and reasonable earnings

growth possibilities. Quality financial statements, coherent management and an operational business plan need to be in place before we rank a company "green".



Do not hold

Considering a decision

Hold







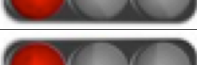
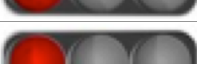





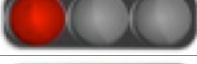
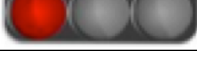

	INDUSTRY	Current Status
Tiffany & Co.	Consumer Discretionary	
Coach Inc.	Consumer Discretionary	
Ralph Lauren	Consumer Discretionary	
VF Corp.	Consumer Discretionary	
Estee Lauder	Consumer Discretionary	
Nike Co.	Consumer Discretionary	
Gap Inc.	Consumer Discretionary	
Ford Motor	Consumer Discretionary	
McDonald's Corp.	Consumer Discretionary	
Starbucks	Consumer Discretionary	
Sysco Corp.	Consumer Discretionary	
Ross Stores	Consumer Discretionary	
Dollar Tree	Consumer Discretionary	
Nordstrom	Consumer Discretionary	

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QUBE INSIGHTS: Equity Research Snapshots

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	INDUSTRY	Current Status
Target Corp.	Consumer Discretionary	
Mattel	Consumer Discretionary	
Priceline	Consumer Discretionary	
Campbell Soup Company Ltd.	Consumer Discretionary	
General Mills Inc.	Consumer Discretionary	
H.J. Heinz Co.	Consumer Discretionary	
Kellogg Co.	Consumer Discretionary	
Coca-Cola Company	Consumer Discretionary	
Coca-Cola Enterprises (bottler)	Consumer Discretionary	
PepsiCo	Consumer Discretionary	
Monster Beverage	Consumer Discretionary	
Mondelez	Consumer Discretionary	
Clorox Company	Consumer Discretionary	
Colgate Palmolive	Consumer Discretionary	
Kimberly Clark	Consumer Discretionary	
Procter and Gamble	Consumer Discretionary	



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Commissions, management fees and expenses may be associated with investment accounts. Please read the simplified prospectus (if applicable), or investment management agreement before investing. Many investments are not guaranteed and are not covered by the Canada Deposit Insurance Corporation or by any other government issuer. There can be no assurances that an investment will be able to maintain its net asset value or that the full amount of the investment will be returned to you. Values change frequently and past performance may not be repeated.

Qube Investment Management Inc. is a registered portfolio management firm in the Provinces of Alberta and British Columbia and was registered as a portfolio management firm on June 25, 2012. Any return period cited before this date was prior to QIM being registered as a portfolio

management firm. Inception was Jan 1, 2011 and all returns are for a modeled portfolio initiated at \$500,000. Your actual returns may vary according to your individual portfolio. The modeled returns are calculated inclusive of dividends, adjusted to the Canadian currency, and are determined via the IRR (Internal Rate of Return) method. The gain/loss shown are simple (non-compounded) returns for periods up to one year. If the time since inception date is more than one year, then the return shown is an annualized return. For comparison purposes, the Kaleo model(s) are reported as gross returns before investment management fees. Individual investor level returns will differ as the fees agreed to in your Investment Management Agreement (IMA) are subtracted from the gross return.

At any one point in time, the composition of the Kaleo model may change. Currently, the focus for our models (Kaleo A, B and Full) is to invest in a globally diversified portfolio of liquid stocks with a minimum market capitalization of \$1 billion. Our diversification strategy is to have similar industry weightings between our Kaleo models A, B and Full, which in turn will have similar weightings to the S&P 500. Our investment

mandate is to not have any one industry sector or sub-group exceed 2.0 times the percentage weighting assigned to that group by the S&P 500 index unless the sector or sub-group composes less than 5% of the total index. Please refer to your Investment Policy Statement (IPS) for more details.

Index comparisons are based on the total return index provided by Standard & Poor's for both the S&P/TSX and the S&P 500. All index returns are inclusive of dividends, adjusted to the Canadian currency, and, similar to the modeled portfolio, determined via the IRR method. Please note that, as total return indices are not actual portfolios, these returns do not include the cost of management and/or trading fees.

Past performance is not indicative of future results and there is no assurance that our model portfolio will achieve its objectives or avoid significant losses









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