TETREM CAPITAL MANAGEMENT

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TETREM

QUARTERLY REVIEW

DODGING DISRUPTION

Just as investors started to allow themselves a little mental relaxation in anticipation of summer, the British trampled nerves by voting for "Brexit" from the European Union. Consequently, uncertainty has been extended, casting a shadow over the global economic environment as we enter July. At least we have the Rio Olympics to look forward to. After an initial two-day plunge in equity markets, stocks staged a rally, largely regaining initial losses and once again demonstrating the folly of attempting to trade markets on macro headlines. In a world with negative interest rates, equities offer real value, particularly those that pay dividends backed by persistent corporate cash flows. Like it or not, macro issues are here to stay and a rising wave of electoral populism can now be added to the list of concerns. However, one only need look at the long-term returns of developed market equities to see that, through all of the political change, wars and recessions, the stock market creates wealth. Capitalist economies are good at evolving and adapting to change, the one constant in an uncertain world.

One of my lasting impressions, when I graduated from business school in 1989, was the pace of technological progress. A paper from that year made the bold prediction that, while we experienced significant advances in technological innovation in the 1980s, the rate of change was set to accelerate tenfold over the ensuing decade. While it is difficult to precisely quantify the overall rate of technological change since then, both objective and subjective observations indicate that the prediction was accurate, if not conservative. Objectively, Moore's law states, and experience has shown, that computer processing power doubles every two years, providing the raw computing power for technological progress. Subjectively, over the past two and half decades we've gone from Gordon Gecko lugging around a Motorola brick cell phone in the movie *Wall Street* to shared family plans for smartphones in the wake of ubiquitous adoption.

While Brexit and similar macro shocks create immediate and dramatic impacts on market levels, the stealthier threat is the exponential adoption of disruptive technologies. In their book *Bold*, Peter Diamandis and Steven Kotler illustrate the story of Kodak and how the company rapidly went from American icon to bankruptcy due to the exponential adoption of digital photography, a technology that Kodak invented and then resisted. Today we are witnessing first-hand the implosion of the taxi cab industry which Uber is disrupting with a more satisfying and economical alternative. Without question the adoption of ride sharing services would be even more rapid were it not for political resistance. At one time each of Kodak and taxi cab license owners were thought to possess impregnable economic moats. It has become clear that no company is impervious to technological disruption, neither the Fortune 500 nor the disrupters themselves who, in turn, are under constant threat from emerging upstarts.

Tetrem's investment team has always analyzed the risks of disruption to existing and potential investments. There is no way to eliminate the risk given the existential threat to a vast array of industries, not to mention the basic difficulty of predicting the path of future technological development and adoption. Our main focus has been on risk mitigation, particularly as it relates to companies that operate in industries that face secular decline. As value investors we first ask if the challenges to an out-of-favour company are secular or cyclical in nature. If we believe the former, which more often than not is due to disruption, we move on and look for other opportunities. Over the past year we have been adding capital to CN Rail and Union Pacific in the Canadian and US portfolios, respectively. The rail industry is facing near-term volume challenges due in part to the commodity bear market and soft economic growth. However, the industry is using this soft patch to improve efficiencies while maintaining pricing power. The rails maintain networks and access points that cannot be recreated, providing them with wide economic moats. And yet, even the rails face threats. Their economic advantage over trucking, particularly as it relates to long-haul movement of goods and access into physically congested geographies, will likely be eroded — though not eliminated — by autonomously driven trucks. As long as we as a society continue to consume goods, particularly those with mass, the rails will do just fine.

We have been wary of the Retail sector for some time. While "bricks and mortar" retailers' stocks show up well in value screens, they face both cyclical and secular issues which increase the likelihood that many of them are value traps. Shopping behaviours have changed and consumers increasingly favour online merchants, a trend that is likely to persist. Certain exceptional retailers that offer services and experiences that are difficult to replicate online will prosper, but overall it seems that the physical retailers face unrelenting headwinds.

Playing offense to profit from technological disruption is more nuanced. Companies that are viewed as disruption winners are neither contrarian nor value. Ominously, those perceived as winners today can quickly morph into losers as they themselves become disrupted. The technology junkyard is littered with one-time high flyers – remember AOL? – that were going to change the world, only to become yesterday's story. Today Netflix is disrupting the media industry as consumers stream content and cut back on both broadcast and cable television viewing. It is fair to question if Netflix will remain a preferred portal for media consumption (Continued on page 4)

MARKET OVERVIEW

- The S&P/TSX Composite returned 5.1%, continuing the prior quarter's positive trend. Natural resource stocks led the charge. The Gold and Energy sectors advanced 40.8% and 9.5%, respectively.
- An estimated $25 billion of foreign buying in the past eight months put upward pressure on the market, even as Canadians were net sellers of domestic stocks. At mid year, the TSX was the best performing developed market in 2016.
- Bond yields remained low, benefitting higher-yielding equity sectors such as Pipelines, Utilities and Real Estate.

S&P/TSX SECTOR PERFORMANCE

Sector	Quarterly Total Return (%)
Materials	26.9
Energy	9.5
Utilities	7.0
S&P TSX	5.1
Telecommunication Services	3.0
Financials	1.3
Industrials	1.2
Consumer Discretionary	-2.9
Consumer Staples	-4.1
Information Technology	-5.9
Health Care	-15.3

TETREM'S TOP TEN CANADIAN POSITIONS

Security	Weight (%)
Royal Bank Of Canada	7.4
Toronto-Dominion Bank	7.3
Bank Of Nova Scotia	6.4
Cash	4.5
Manulife Financial Corp	4.0
Canadian Imperial Bank Of Commerce	4.0
CCL Industries Inc	3.9
Canadian National Railway Co	3.9
Keyera Corp	3.4
Agrium Inc	3.0
	47.8

NOTEWORTHY PORTFOLIO CHANGES

▲	iShares S&P/TSX Global Gold	▼	Power Corp Of Canada
▲	Royal Bank Of Canada	▼	Thomson Reuters Corp
▲	Agrium Inc	▼	Manulife Financial Corp

TETREM'S QUARTERLY RESULTS

- Tetrem's Canadian Equity Portfolio advanced 1.8% inclusive of dividends during the quarter, lagging the benchmark by 335 basis points.
- Stock selection in the Energy sector contributed positively, as did being underweight the underperforming Consumer Staples and Health Care sectors.
- Positioning within the Materials sector, in particular not owning gold stocks, accounted for over 90% of the relative underperformance. Non-Bank Financials were also a drag on results.
- Notable positive contributors: Canyon Services Group, Uni-Select, Quebecor.
- Notable detractors: CCL Industries, Magna International, CGI Group.

MANAGER COMMENTARY

Portfolio holdings Precision Drilling and Canyon Energy Services, which are highly sensitive to activity in the oil patch, were big contributors to the portfolio's results. A recovering oil price was seen to suggest the worst is over for the energy services industry, where significant capacity has been removed. Strong companies such as Precision and Canyon are well positioned to gain market share when their customers increase their drilling and fracking activity. To be clear, confidence in the oil patch remains low and timing is always uncertain, but it appears to us that conditions will continue to improve while investor skepticism remains high – a combination we like.

We exited Thomson Reuters, a position that contributed solidly to the portfolio over the past few years. In 2012 we were buying shares aggressively on the view that management's cost cutting initiatives would result in higher profit margins, dividends and share buybacks. This played out over the subsequent years, and with the share price outpacing the underlying fundamentals, we locked in profits.

The UK electorate's surprising decision to exit the European Union has put a damper on expectations for global growth, pushing bond yields lower. In a low-growth environment, we believe it likely that equity returns will be modest relative to history, and that a meaningful portion will come from dividends. While low interest rates pressure the earnings of Financials – the largest sector in the Canadian market – they also support borrowers' ability to repay their debt obligations. On that note, we continue to think that the earnings outlook is stable for portfolio holdings such as Toronto-Dominion Bank and Royal Bank. The stocks offer attractive total return potential given their solid dividend yields combined with respectable expected earnings growth. Conversely, low rates are a mightier headwind for life insurance companies, which we have trimmed.

The portfolio now holds Waste Connections as a result of a merger with Progressive Waste Solutions, a transaction that helped unlock value. We purchased additional shares after analyzing the combined entity. Our conclusion was that Waste Connections' seasoned management team will be able to create value by optimizing the asset base. Landfill sites have high barriers to entry and beget long-term earnings visibility. We foresee continued peer-leading free cash flow margins and growth, which the market should reward.

Alec MacIsaac, CFA *Principal & Portfolio Manager*

TETREM'S CANADIAN EQUITY PORTFOLIOS - HISTORICAL PERFORMANCE (% return denominated in CDN$ - see performance disclosures at end of page 4)

			Annualized Returns to June 30, 2016										
	Q2 2016	YTD	1 year	3 year	5 year	10 year	15 year	Since Inception	2011	2012	2013	2014	2015
TETREM CANADIAN EQUITY COMPOSITE													
Gross of Fees	1.8	4.6	-4.7	5.9	3.3	3.8	8.7	9.4	-11.9	8.8	25.7	5.7	-8.8
Net of Fees	1.6	4.2	-5.3	5.2	2.6	3.1	8.0	8.7	-12.5	8.1	24.9	5.0	-9.4
S&P / TSX Total Return Index	5.1	9.8	-0.2	8.3	4.2	4.9	6.8	7.0	-8.7	7.2	13.0	10.6	-8.3
TETREM CANADIAN EQUITY DIVIDEND COMPOSITE													
Gross of Fees	3.1	8.7	3.3	8.5	-	-	-	9.3	-	-	23.4	4.8	-5.5
Net of Fees	2.9	8.3	2.6	7.8	-	-	-	8.5	-	-	22.6	4.2	-6.1
S&P / TSX Total Return Index	5.1	9.8	-0.2	8.3	-	-	-	7.2	-	-	13.0	10.6	-8.3

MARKET OVERVIEW

- The S&P 500 finished the second quarter up 2.5%. Through the first half of 2016 the S&P 500 returned 3.8%, outpacing most developed market indices.
- The Energy sector was the top performing sector finishing the quarter up 11.6%. Year to date the Energy sector has returned 16.2%.
- Low global bond yields have pushed US equity investors into sectors with dividend yield and perceived stability. Health Care, Telecommunication Services and Utilities generated another quarter of above-market returns.

S&P 500 SECTOR PERFORMANCE

Sector	Quarterly Total Return (%)
Energy	11.6
Telecommunication Services	7.1
Utilities	6.8
Health Care	6.3
Consumer Staples	4.6
Materials	3.7
S&P 500	2.5
Financials	2.1
Industrials	1.4
Consumer Discretionary	-0.9
Information Technology	-2.8

TETREM'S TOP TEN US POSITIONS

Security	Weight (%)
Cash	6.3
Alphabet Inc	5.8
Microsoft Corp	4.7
Johnson & Johnson	4.3
Spectra Energy Corp	3.7
Pfizer Inc	3.5
Corning Inc	3.4
American International Group	3.3
Dow Chemical Co	3.3
EOG Resources Inc	3.1
	41.3

NOTEWORTHY PORTFOLIO CHANGES

▲ Qualcomm Inc	▼ Capital One Financial
▲ Mckesson Corp	▼ Walt Disney Co
▲ Crown Castle Int'l Corp	▼ Apple Inc

TETREM'S QUARTERLY RESULTS

- Tetrem's US Equity Portfolio increased 3.3% inclusive of dividends during the quarter, leading the S&P 500 by 84bps.
- Stock selection within Energy, Health Care and Industrials contributed positively to performance.
- Portfolio positioning within Consumer Discretionary and Information Technology negatively impacted performance.
- Notable positive contributors: Spectra Energy, Halliburton Co, Pfizer Inc.
- Notable detractors: Macy's Inc, Harley-Davidson Inc, Capital One Financial.

MANAGER COMMENTARY

With the Brexit vote behind us, the market is left pondering how the United Kingdom's decision to "leave" the European Union will change the Union's future. The uncertainty has drawn investor capital into perceived safe havens, such as gold and government bonds, the latter of which are now at historically low yields. As long-term-focused value investors we do not position our portfolios based on predictions about which EU member will be next to hold a referendum, or the outcome of the US presidential election, for that matter. However, we do believe the uncertain environment will reward quality companies that offer sustainable dividend growth. This is where we are focusing our research efforts.

The oil rebound continued through the second quarter as evidence emerged of a more balanced energy market. One data point is the United States Oil Rig Count, a proxy for future supply, which ended the quarter at 330 rigs, down from 628 rigs one year ago. Our Energy sector focus continues to be on quality companies we believe will be winners through the cycle. An example is Spectra Energy, a midstream oil & gas company with a 4.4% dividend yield. Over the last five years the dividend has grown by 7% annually, a trend we expect to continue.

In the quarter we initiated a position in Qualcomm Inc, a designer, manufacturer and licensor of chips used primarily in smartphones. The shares trade at a discount to the market and their own history due to investor concerns over 2016 earnings growth. While uncertainty is understandable given the maturation of the smartphone market, we believe a longer-term outlook is warranted. Qualcomm will be the prime beneficiary of both the 5G upgrade cycle and the trend of increased connectivity between devices. The market's near-term focus has provided us with the opportunity to initiate a position in a quality company with a growing dividend that currently provides a yield of 4.1%.

The portfolio remains balanced between deeper value companies, such as Qualcomm, and reasonably valued quality companies with the ability to compound earnings and dividends. Microsoft is an example of the latter. The company continues to gain share from competitors as enterprise spending moves from on-premise to the cloud. This gives us confidence in Microsoft's ability to continue growing sales, cash flow and the dividend. At quarter end the shares provided investors with a yield of 3%; we expect the dividend payment to grow by a double-digit rate into the foreseeable future.

Daniel A. Bubis, CFA *President & Chief Investment Officer*

TETREM'S US EQUITY PORTFOLIOS - HISTORICAL PERFORMANCE (% return denominated in US$ - see performance disclosures at end of page 4)

			Annualized Returns to June 30, 2016										
	Q2 2016	YTD	1 year	3 year	5 year	10 year	15 year	Since Inception	2011	2012	2013	2014	2015
TETREM US EQUITY COMPOSITE													
Gross of Fees	3.3	2.0	-2.2	8.1	8.4	6.4	8.3	9.9	-7.1	10.3	37.9	9.9	-3.9
Net of Fees	3.1	1.7	-2.8	7.4	7.7	5.7	7.6	9.2	-7.8	9.6	37.0	9.2	-4.6
S&P 500 Total Return Index	2.5	3.8	4.0	11.7	12.1	7.4	5.8	7.5	2.1	16.0	32.4	13.7	1.4
TETREM US EQUITY DIVIDEND COMPOSITE													
Gross of Fees	6.3	10.4	12.0	13.0	-	-	-	15.9	-	-	34.3	14.8	0.1
Net of Fees	6.1	10.1	11.3	12.3	-	-	-	15.2	-	-	33.4	14.1	-0.6
S&P 500 Total Return Index	2.5	3.8	4.0	11.7	-	-	-	14.0	-	-	32.4	13.7	1.4

(continued from page 1)

or instead succumb to new services that consumers switch to as the media industry adapts and new entrants emerge.

Alphabet (née Google), the largest holding in Tetrem's US equity portfolios, is a massive disruptor in media as advertising dollars continue to transition online. Google may be the best media company on the planet, yet valuation, at under 20 times earnings, has been restrained. Investor skepticism results from Google's capital spending on "moon shot" investments, some of which look to be on the verge of success. One example is autonomous driving, an initiative that appears inevitable in the coming years, and an area in which Google is miles ahead of the competition. Likewise, artificial intelligence may be the most disruptive technology yet, and Google is a leader in this space. This is not the dystopian artificial intelligence as seen in movies such as *Terminator*, but the artificial intelligence that provides relevant answers to a search query or allows autonomous vehicles to be safer and more efficient than those driven by people. Simply put, Alphabet is well positioned to continue driving the disruption bus for years to come, yet its shares are valued at a multiple similar to that of the S&P 500.

Within the Canadian market there is less breadth of investible technology opportunities, with Blackberry standing out as a textbook example of how a disruptor can very quickly be disrupted. Fortunately, in Canada there are a number of industries with oligopolistic structures that offer investors a level of protection from disruption. The much-derided airline industry is one example. Portfolio companies Air Canada and WestJet are rational competitors that are focused on achieving an attractive return on capital, eschewing the old ways of growth at any cost. Similar to the rails, Canadian airlines have been out-of-favour with investors, largely over cyclical concerns. From a secular perspective there is little in the way of technology that will offset the increasing demand for air travel, providing the airlines with an investment attribute that should not be ignored.

Investing in disruptive winners is risky, particularly given their lofty valuations. As is often the case with investing, the better approach is to avoid losers and, therefore, losses. As for winners, it seems that much of the benefit from disruption will flow to Joe and Jane Consumer who derive greater utility by purchasing goods and services at lower prices and increased convenience. The overall economy is also likely to be a winner. Much has been made of the anemic economic growth in North America since the Great Recession, with a major culprit being the lack of productivity improvement. However, there is a growing school of thought that argues economic statisticians are improperly accounting for increases in productivity from the adoption of new technologies. If productivity is in fact higher than what is currently being reported, so too is real economic growth, which would set the stage for equities to re-rate higher.

Whenever one discusses the future, there are more questions than answers. In an uncertain world, we continue to focus on quality blue chip companies that offer sustainable dividends, while avoiding companies that face secular threats.

Daniel A. Bubis, CFA *President & Chief Investment Officer*

ABOUT TETREM

Tetrem Capital Management offers money management services to institutional and private clients. Our investment portfolios are focused on Canadian and US equities, rooted in our long-standing contrarian value style and tailored to the specific needs of our clients.

Investing is our profession and we are committed to doing it well. Our experienced team's primary focus is seeking out and investing in undervalued companies. For each of our investment portfolios, we employ fundamental and quantitative analysis in our rigorous stock selection process, with a focus on preserving and growing our clients' assets.

For more information about Tetrem Capital Management please visit our website, www.tetrem.com, or call and ask to speak with us about our investment services.

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Performance Disclosure

Tetrem Capital Management Ltd., an independent investment management firm, claims compliance with the global investment performance standards (GIPS®). To receive a complete list of composite descriptions please contact us at the above phone number.

To receive a presentation that adheres to the GIPS standards, please contact us at the above phone number or see the "performance" section of our website at www.tetrem.com.

Composite Descriptions:

Tetrem Canadian Equity Composite
Contains fully discretionary Canadian equity accounts following a value investment strategy. Inception date: January 1, 1997.

Tetrem US Equity Composite
Contains fully discretionary US equity accounts following a value investment strategy. Inception date: January 1, 1997.

Tetrem Canadian Equity Dividend Composite
Contains fully discretionary Canadian equity accounts following a value investment strategy with stocks that pay a dividend or are expected to pay a dividend. Inception date is November 30, 2012.

Tetrem US Equity Dividend Composite
Contains fully discretionary US equity accounts following a value investment strategy with stocks that pay a dividend or are expected to pay a dividend. Inception date is November 30, 2012.

Returns represent past performance. Returns stated within this newsletter are gross of fees unless otherwise indicated. Past performance does not guarantee future results. Different types of investments involve varying degrees of risk.

The S&P/TSX Composite Total Return Index comprises approximately 71% of the market capitalization for Canadian-based, Toronto Stock Exchange listed companies and provides broad economic sector coverage of the Canadian markets.

The S&P 500 Total Return Index consists of 500 stocks chosen for market size, liquidity, and industry group representation.

Tetrem's mandates are available to institutional investors such as pension plans, group retirement plans and foundations and certain individual investors who meet specified investment criteria. The mandates' performances are not guaranteed, the values change frequently and past performance may not be repeated.

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