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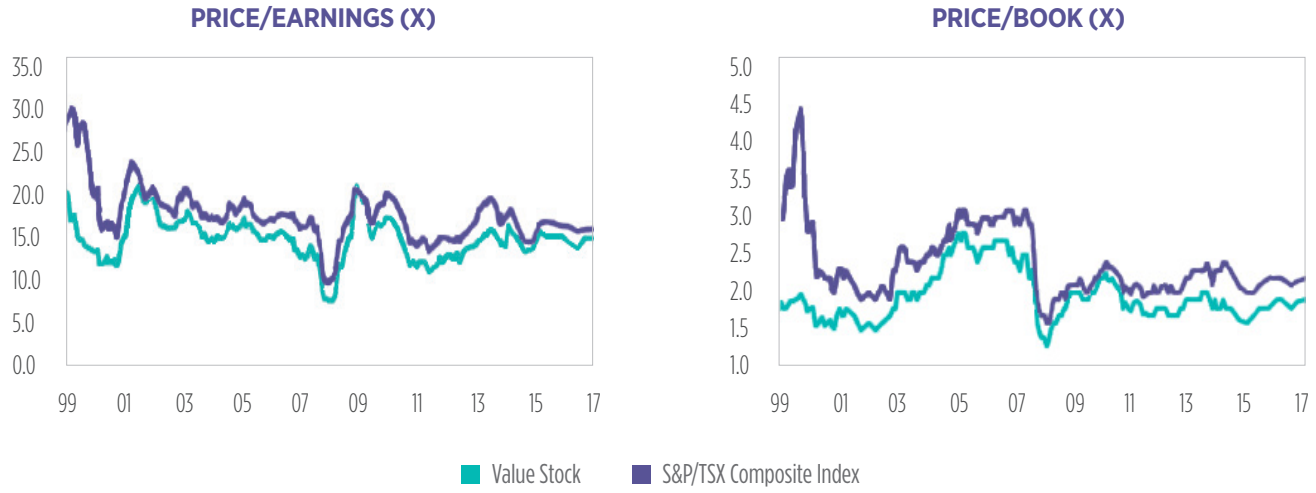
A Concentrated Approach to Canadian Value Investing

WHAT IS VALUE INVESTING?

Value investing seeks to identify undervalued companies with the belief that the overall market will recognize its true value and the price of the company's stock will rise. Such companies typically trade at price-to-earnings (P/E) and price-to-book (P/B) multiples that are below valuations at which the overall stock market is trading, as illustrated in the charts below.

A value style of investing often implies being contrarian to the general market consensus. Historically, this approach has typically resulted in less volatile returns and better protection during large market declines.



For illustrative purposes only.

VALUE INVESTING HIGHLIGHTS

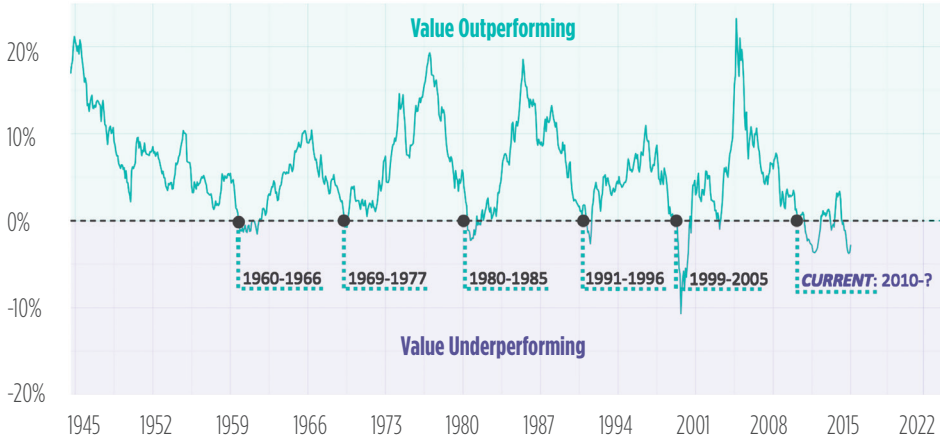
Philosophy	Invest in a company for less than it's fundamental worth since the market doesn't believe it is currently worth more; but there is a belief (among value investors) that it could be worth more in the future.
Portfolio Metrics	Buy at a discount to the market multiples on: • Price/Earnings • Price/Book Value • Price/Replacement Value
Challenges	Requires patience, as it can take time to see the price of a particular stock increase.

WHY INVEST IN VALUE STOCKS NOW?

Market cycles mean that investment styles come in and out-of-favour over time. For example, at times large cap stocks can dominate market returns, while at other times small cap stocks take the lead. The competing style to value investing is a growth approach. Growth investing seeks to identify companies that are expected to grow faster than the market, such as growth in revenue or profitability. A growth style of investing is usually less focused on capital protection and will therefore generally exhibit greater volatility.

While growth style investing has been ahead of value on a rolling 5-year basis, most recently (see chart on next page), over shorter-term periods, the leadership appears to be changing. In particular, the valuation gap between growth and value styles from a global perspective is the largest for over a decade.

VALUE INVESTING HAS UNDERPERFORMED GROWTH ONLY SIX TIMES SINCE 1945



Value vs. Growth
(annualized 5 year rolling value outperformance)

All performance information is hypothetical and not the actual performance of an investment fund. Historical performance is not necessarily indicative of future performance.
Source: Euclidean Technologies, http://www.euclidean.com/time-to-add-capital-to-value-investing

From an economic perspective, global economies are growing in synch for the first time in many years with China and India's gross domestic product above 6%, and the Eurozone, U.S. and Canada coming in above 2%. Add to this, declining unemployment, low wage growth, improving consumer confidence and strong corporate earnings growth (plus the added bonus of the Republican's tax reform), and we have an economic background that supports growth and an environment where interest rates should continue to rise.

While Canadian companies won't see the same direct earnings pick-up, ancillary benefits are expected: stronger capital expenditures; Canadian companies with U.S. subsidiaries; and a general improvement in business sentiment. The implied Equity Risk Premium (the additional return required to invest in equities instead of bonds) is approximately 4.5%, which is at the high end of the historical range, making value equities, which are trading at a discount to the market multiples, even more attractive.

BENEFITS OF A CONCENTRATED APPROACH

Active funds that combine a large number of stock holdings and small deviations from the index weightings are limited in their ability to add value. In contrast, a concentrated portfolio, where the investment manager's philosophy implies taking large educated deviations from the index weightings, increases the level of added value potential.

A concentrated portfolio has fewer portfolio names, resulting in a high active share, which is a measure that compares the active weights versus the index weights. The resulting portfolio will be more volatile relative to the index (tracking error) compared to a less concentrated portfolio. However, from an absolute return perspective, a concentrated value style of investing aims to preserve capital by investing in companies with strong balance sheets.

THE CASE FOR CONCENTRATED CANADIAN VALUE EQUITY

A value style of investing paired with a concentrated approach to portfolio construction offers investors a strong combination.
A concentrated portfolio, where the investment manager takes large educated deviations from the index weightings, increases the level of added value potential. A value investing approach aims to provide less volatile returns and better protection during large market declines.

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Ninepoint Partners LP: Toll Free: 1.866.299.9906. DEALER SERVICES: RBC Investor & Treasury Services: Tel: 416.955.5885; Toll Free: 1.877.874.0899

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