ABC FUNDS
I.A. MICHAEL INVESTMENT COUNSEL LTD.

The ABC Perspective

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PRESENT PERSPECTIVES

The New Horizon

Over the past nine months we have made a number of important changes to upgrade and improve our operations and to reinvigorate our investment performance. In all candor, it has not been an easy task considering the significant stock market volatility and currency variability. Nonetheless, numerous modifications we have made include:

- *a move to a new office location,*
- *hired new additional administrative and client service personnel to build up our administrative team, dividing our operations into two pods: 1) for administrative services and 2) for accounting services. We will continue to upgrade our administrative and accounting operations,*
- *hired a new investment analyst and upgraded our portfolio management team. We instituted a revitalized value common share search for unrecognized free cash flow (FCF) North American common stocks. During this period we have uncovered 25-35 new ABC purchase candidates. At the same time we significantly reduced our natural resource exposure,*
- *installed a new accounting system on the administrative side, which is now providing greater accuracy and simplicity when evaluating and pricing our ABC Funds,*
- *we are continually expanding/upgrading compliance responsibilities. For instance, with regard to Know Your Client (KYC) information we have instituted an electronic KYC to provide for easier client feedback and to comply with the new FATCA rules, etc.,*
- *we have updated our websites. More importantly, we provided a new online video of our regular quarterly meetings to inform clients and prospects who are unable to attend,*
- *we are preparing a new offering memorandum and due to important changes in securities regulation we will be reducing the investment minimums for all five ABC Funds,*
- *our auditors PWC have just completed the annual audit for our ABC Funds and everything appears to be as expected and satisfactory,*
- *having purchased numerous American common stocks and to mitigate currency exposure we initiated a Canadian/U.S. dollar currency contract with the Royal Bank of Canada and will continue to hedge as long as our ABC Funds hold substantial U.S. dollar exposure,*
- *we are initiating a new marketing campaign as we are in the process of setting up a marketing department. More information will follow shortly.*

We are confident that these changes are very positive for achieving our longer term goals of good service and superior performance. While our team is dedicated to these improvements, it has taken time for the positive effects to be realized. We believe that we are now at the cusp of this visibility.

With regard to our investment portfolios we have added a number of unrecognized, free cash flowing value stocks over the past six months. On the Canadian side we have added and/or purchased: Pure Industrial REIT, Plaza Retail REIT, InterRent REIT, Uni-Select Inc., TransForce Inc., Exco Technologies Ltd. and Polaris Materials. A partial list of American common stocks include: Activision Blizzard Inc., Bed, Bath & Beyond, Big Lots Inc., Carriage Services Inc., Cooper Tire and Rubber Co., Express Scripts Holding Co., Foot Locker Inc., Gilead Sciences, Las Vegas Sands Corp., Micron Technology Inc., Parker Hannifin Corporation, Regal -Beloit Corporation and The Gap Inc.

Looking ahead, our investment team is extremely focused on our value search and we are diligently working together as we carry out our plan of action. More importantly, we repositioned our portfolios over the past six months and we are now very comfortable with our relatively liquid, strong list of common stock holdings. We look forward to the next nine months of 2015.

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ECONOMIC PERSPECTIVES

U.S. Jobs Growth: Fueling the Economy

Since the start of the 2009 economic recovery, one of the greatest concerns confronting the United States was job creation. With record low interest rates, substantial monetary ease, low inflation and the significant improvement in both the automobile and housing sectors, over the past year, more than 3.3 million Americans found jobs and the unemployment rate fell to 5.5%.

Although it may be too much to expect over 200,000 jobs to be created each month, the fact is that rising employment is a key positive driver for consumer spending, government deficits, corporate profits and, ultimately, common stock prices. While it will be extremely difficult to duplicate the past year's job growth since the U.S. economy will eventually tilt toward full employment, we do expect that even moderate job growth will continue to fuel American business activity. Moreover, given the psychological boost of finding a job and the recent decline of gasoline prices, we believe that a cheery American consumer should provide additional traction for consumer spending to elongate the U.S. economic cycle.

INVESTMENT PERSPECTIVES

Looking South for Opportunities

While Canadian equities should benefit from a lower Canadian dollar via a pickup in Canadian manufacturing exports, potential merger and acquisition activity by U.S. corporations, low interest rates and generally higher earnings per share, investment choices tend to be rather limited. The acknowledged fact is that share selection within the Canadian stock market is comparatively thin in contrast to the immense public security opportunities in the United States. True, the elevated U.S. dollar makes American stock purchases rather expensive for Canadian investors however, currency hedging contracts can mitigate much of this risk. As a result, over the past six months, we have significantly increased our U.S. holdings having favoured certain American business sectors such as consumer discretionary/retailing, technology, industrials and specialized health care companies. From our research we have found that many of these American selections offer excellent free cash flow yields, attractive dividends and substantial common share liquidity.

PORTFOLIO PERSPECTIVES

Purchasing U.S. Stocks

Over the past three months, we continued to adjust our ABC portfolios by significantly reducing our Canadian natural resource holdings and using the proceeds to purchase a diversified mix of U.S. stocks. All of the American purchases were free cash flowing and offered excellent trading liquidity to our portfolios. To mitigate our U.S. dollar exposure we initiated a Canadian/U.S. dollar currency hedge with the Royal Bank of Canada to cover approximately 30% of this risk.

In Canada we made three new common stock purchases including Exco Technologies Ltd., InterRent REIT and TransForce Inc. Our new U.S. stock purchases included: Activision Blizzard, Bed, Bath & Beyond, Carriage Services Inc., Express Scripts Holding Co., Foot Locker Inc., Gilead Sciences, Industrias Bachoco, Las Vegas Sands Corp., Micron Technology Inc., Parker Hannifin Corp., Qualcomm Inc., SP Plus Corp., The Gap Inc., and Whirlpool Corp.

I often review this piece written almost six years ago to put the securities markets in perspective. The fact is there are times when investment analysts and portfolio managers experience difficult performance periods until new, potentially profitable common stock selections catch on to rejuvenate disappointing investment returns. Until that event, spreading impatience, second-guessing, growing client criticism and frustration can become all pervasive before a series of positive "pick-me-ups" occur. While still somewhat early, it is my view that our free cash flow (FCF) common stock selection process is starting to bear fruit and that superior performance is close at hand.

The following is an excerpt from the ABC Perspective – July 2009 – Pg. 16

A Pick-Me-Up

Quite often a portfolio manager struggling in a difficult market will search relentlessly for a few new, extraordinarily-undervalued common stocks to rejuvenate a stale portfolio. These fresh selections are sometimes controversial in that they appear to bear somewhat more risk in a risk-averse economic environment. Nonetheless, these underrated and contrarian selections represent exceptional opportunities that might have been frequently overlooked in a skittish marketplace. I refer to them as "pick-me-ups."

Pick-me-ups, in my opinion, are important for at least three reasons:

1. they tend to be rather contrarian and might have languished for a long period with investors considering the security to be inappropriate for uncertain times;

2. they offer excellent risk/reward potential largely due to investors' general reluctance to review the shares;

3. a pick-me-up's ultimate success becomes a meaningful psychological and confidence booster to a portfolio manager.

Simply put, by recalibrating an investment portfolio and by refreshing a stale bunch of holdings with a few appealing pick-me-ups, this action will not only improve investment performance but also should invigorate or embolden the portfolio manager. In short, aside from the obvious improvement of portfolio returns, the point to be made is that investment managers are, at the same time, both professional and very human. In consequence, an investment win in a rather morose market environment will often provide the manager with a new edge, boost or incremental confidence. A lift in a manager's self-assurance in an all-pervasive risk-averse market will frequently encourage the manager to search for more extraordinary stock selections in a normally complacent setting.

Interestingly, most portfolio managers have experienced serious feast or famine performance streaks during their careers. These difficult periods are not only trying on the patient and loyal client, but also, they heap increasing pressures on the portfolio manager to perform. In consequence, the growing strain on the investment manager to turn around performance grows in crescendo, similar to a dog chasing his tail.

As difficult as it may be, the successful manager will try to block out the intensifying pressure and sense of urgency to diligently research new selections. The added incentive of making a personal comeback, by sticking to one's stock picking disciplines, fuels the selection of two or three new favourites needed to regain a portfolio's momentum. Ultimately with a few well-selected pick-me-ups the ensuing improved performance is not only inspiring to the manager but more importantly becomes a vital catalyst to the manager's return to investment excellence.

Irwin A. Michael, CFA

Exco Technologies Ltd.

Exco Technologies Ltd. is a global manufacturer of dies, steel moulds, equipment, components, and assemblies to the die-cast, extrusion, and automotive industries. The company's customers include manufacturers of aluminum extrusion, automotive parts, consumer appliances, and other industrial products. After its purchase of Automotive Leather Company Group (ALC) in 2014, the company began supplying interior leather trim and netting to the automotive industry. Exco has operations across the globe including the United States, Canada, Europe, Mexico, South America, and Asia.

Exco Technologies represents an attractive investment opportunity for several reasons. Firstly, Exco trades below a forward EV/EBITDA ratio of 8.0x and below a price/earnings ratio of 15.0x. Moreover, the company is free cash flowing and has a 1.60% dividend yield. Although Exco Technologies is trading cheaply for a Canadian non-resource company, it also offers an impressive growth profile. Over the past four years, the company has exhibited remarkable growth in sales and earnings per share and we believe that this trend will continue due to many of Exco's business initiatives.

Exco Technologies' prime business segment is its Automotive Solutions division, accounting for 54% of its fiscal 2014 sales (including 7 months of ALC sales). This segment is a low cost producer with facilities in Mexico, Morocco, and Bulgaria. These company assets are strategically located in Free Trade Zones near U.S. and European markets. Beyond an attractive cost regime and favourable geographic regions, we believe that Exco's Automotive Solutions division is poised to outperform during 2015. Firstly, we believe that the company will continue to grow its market share with its expanding portfolio of new products. Secondly, Exco has a series of initiatives to realize efficiencies in the company, including opening a new facility in Lesotho, resulting in lower labour costs. Thirdly, Exco generates a minority of its sales in Canadian dollars; we believe that there could be significant accretion to earnings considering the ongoing weakness in the Canadian dollar.

Exco's Casting and Extrusion segment has a strong global brand that services a variety of industries. The company has continued to expand its operations by opening up new extrusion tool shops around the world such as in Texas, Colombia, Brazil, and Thailand. We believe that this expansion will better serve its global customer base and widen its business. Moreover, Exco has a strong relationship with the major automobile manufacturers including Chrysler, Ford, Mercedes-Benz, and General Motors, which not only use Exco's die-cast tooling products but also appear to be ramping up their auto sales.

On January 28th, 2015, Exco reported remarkable fiscal Q1 2015 results for the quarter ended December 31st, 2014. Sales were $119.9 million compared to $63.9 million last year due to the acquisition of ALC and a 36% growth rate of its existing businesses. Net income for the quarter was $9.6 million, a 43% increase from last year. More importantly, the company increased its quarterly dividend payment by 25% and reiterated its strong outlook for the remainder of the year. Exco remains confident due to the recovery in the automotive market and the expectation that American and European OEMs will redesign and launch entire new models over the next few years. We believe this momentum will continue throughout the year, especially with a weak Canadian dollar relative to the U.S. currency.

Exco Technologies also presents a strong balance sheet. As of the end of fiscal Q1 2015, the company was net bank debt free and was sitting on a net cash position of $3.3 million. Exco pays a 1.6% dividend yield and has a very manageable 25% payout ratio. We believe that Exco has a rich pipeline of growth initiatives including plans to expand organically. In fact, the growth in automotive parts demand could prompt the company to increase capacity at its Mexican, Moroccan, and U.S. operations. Most importantly, given Exco's clean balance sheet and underleveraged financial position, we believe that Exco has great acquisition potential which could become a positive growth catalyst.

Overall, we believe that Exco Technologies provides notable value in Canada's marketplace. The company trades cheaply on an EV/EBITDA and P/E valuation basis. Moreover, higher OEM demand, lower input costs, a growing automotive parts industry, and a weak Canadian dollar should drive free cash flow higher in the coming quarters.

Activision Blizzard Inc.

Activision Blizzard is a worldwide interactive software company that develops and publishes video games for personal computer (PC), video game consoles, handhelds, mobile and tablets. Based in Santa Monica, California, Activision Blizzard is the world's largest interactive software company and consists of two operating units: Blizzard Entertainment and Activision Publishing.

Activision Blizzard is an attractive investment for several reasons. Firstly, video gaming is an industry with excellent fundamentals since it is one of the fastest growing sectors of the economy. Activision's management estimates global video gaming revenue will grow by 10% per year through 2017, driven by strong growth in China as well as shifts to digital distribution. Additionally, the industry is concentrated with a small number of large publishers selling differentiated products, resulting in an appealing competitive landscape with strong pricing power for the publishers. Finally, barriers to enter the industry are high as business success is highly dependent on ownership of well-known franchises and reputable development studios.

Activision Blizzard has a competitive advantage through the highly valuable intellectual properties it owns. These properties are among the most recognizable gaming franchises in the world. The company's most valuable franchise is Call of Duty, a military action shooter series. The franchise has earned $11 billion for the company since it launched in 2003, and has been the top video gaming franchise in North America for six consecutive years. The latest iteration, Call of Duty: Advanced Warfare was the top selling game worldwide in 2014. Another top franchise is Skylanders, which consists of toys and video games targeted to children. Since its release in 2011, Skylanders has sold over 240 million toys and produced over $3 billion in sales through retail channels. It outsold all action figure lines in 2014 and was the top selling console game for children during Q4 2014. The final core franchise is World of Warcraft, a subscription-based computer game. The game has been a huge success since launching in 2004. It is the top subscription-based game in the world with 10 million subscribers as of Q4 2014. Despite the game's age, it continues to thrive and has successfully fended off every direct competitor. This is largely due to strong brand recognition, deep customer loyalty and development excellence from Blizzard Entertainment.

Looking forward, the growth outlook for the company is promising. Management has laid out several initiatives to grow revenue including investment in new franchises, expansion to new regions and utilization of new business models with higher margins. Management plans to double the number of franchises they own from five in 2014 to ten by the end of 2015. This was notably demonstrated by the introduction of Destiny, a completely new franchise in 2014, which became the #1 new console franchise launch in history. Additional upcoming franchises include Call of Duty Online, Heroes of the Storm and Overwatch which will utilize free to play models. While this model requires time to generate meaningful revenue and earnings, it carries much higher margins. Furthermore, Activision Blizzard plans to ramp up their business in China, which is a rapidly growing market for gaming. Beginning 2013 with only two games in China, ATVI expects to have at least six games in 2015. Finally, the company plans to grow their mobile gaming business, with the company planning to release their successful Hearthstone franchise to iPhone and Android smartphones later this year.

In addition to its appealing fundamentals, Activision Blizzard has a compelling valuation. Based on 2014 normalized EPS of $1.42, the company trades at an inexpensive 16x price earnings ratio. Additionally, the company has a solid balance sheet, holding $4.3 billion in debt offset by cash holdings of $4.9 billion. Most importantly to us however, is the substantial free cash flow the business generates. During 2014, the company generated approximately $1.2 billion in free cash flow, equating to a free cash flow yield of 7.2%. As reported by the company, management intends to use the free cash flow to return value to shareholders. For instance, upon announcing Q4/14 results, the company increased its dividend by 15%, set aside $250 million for debt repayment and instituted a two year buyback plan of $750 million of common shares.

Overall, we are optimistic about the future for Activision Blizzard. We see room for the share price to increase as the company continues to invest in new franchises, grow its free cash flow and return cash to shareholders.

Two Examples of Buying Free Cash Flow: Big Lots Inc. and Cooper Tire & Rubber Inc.

Over the past six months we have focused our value investing search efforts on unrecognized free cash flow (FCF) North American common stocks. Free cash flow is defined as the left over cash that a company retains after paying for its mandatory capital expenditures and other miscellaneous expenses. More importantly, with excess cash, companies are able to repay debt, increase dividends, initiate share buybacks and make accretive acquisitions.

In fact, since last fall we have been hunting for excess cash flowing companies so as to construct portfolios composed of a diversified stream of dependable and growing free cash flow. Two FCF examples purchased in late 2014 which we have previously highlighted in our January 2015 ABC Perspective include:

1. Big Lots Inc., a Columbus, Ohio-based "mini-Walmart" retailer with about 1500 stores concentrating on discount goods generating FCF and paying a 1.6% dividend.

2. Cooper Tire & Rubber Company, an Ohio headquartered manufacturer of replacement tires, free cash flowing beneficiary of low oil prices and increased consumer demand, offering a dividend yield of 1.2%.

Interestingly, both Big Lots and Cooper Tire were purchased by our ABC Funds in December as unrecognized, attractively-priced free cash flowing common stocks since they both offered excellent investment prospects for 2015. In the case of Big Lots, its Q4 fiscal 2014 results announced on March 6, 2015, not only beat both earnings and revenue expectations but, more importantly, the company increased its dividend by 12% to $0.19 a quarter and announced a new $200 million share buyback. This announcement comes after the company had already repurchased 6.1 million shares worth $250 million, paid $28 million in dividends and reduced its debt obligations to $62.1 million from $77 million a year earlier.

Cooper Tire & Rubber's year end results made public on February 23, 2015 included a gain on a sale of a Chinese joint venture, a 10.5¢ quarterly dividend (its 172nd consecutive dividend payment) but more importantly, Cooper announced a $200 million share buyback of the company's outstanding stock through December 31, 2016. Interestingly, Cooper had already completed a $200 million accelerated repurchase program announced in August 2014 by buying back 6.4 million shares at $31.44. Cooper now has only 58.1 million shares outstanding. This declining share count will provide considerable earnings and free cash flow leverage in the future.

From their December 31, 2014 prices to the March 31, 2015 quarter end, Big Lots has increased from $40.03 to $48.03 or +20 % and Cooper Tire has climbed from $34.66 to $42.84 or +23.6%. However, this performance is not to imply that both Big Lots and Cooper Tire are still inexpensive and should improve further. On the contrary, we have prudently trimmed a portion of our ABC holdings to realize profit and may continue to do so. More to the point, we highlight both Big Lots and Cooper Tire as representative examples of the type of common stock that our research team is searching for each day.

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