THE ABC PERSPECTIVE

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Tough Times Don't Last

> **"Tough times don't last;**
> **Tough people do."**
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> **-Robert H. Schuller**

In all candour the past six months have been one of the toughest times investors have faced since the 2008-2009 financial crisis. For instance, the turmoil relating to Greece, Chinese economic deceleration, uncertain U.S. Federal Reserve interest rate intentions, Syria, Ukraine, fickle commodity prices, Volkswagen emissions scandal, first half 2015 Canadian technical recession, a pending too-close-to-call Canadian federal election, etc. have clouded investors' decision-making skills. These circumstances have made stock picking extremely difficult and have enervated portfolio managers' investment enthusiasm amidst extraordinary market price volatility.

But, tough times don't last forever. Admittedly, the current investment environment has been a fatiguing grind for many investors with a good deal of the resulting negativity baked into common stock prices. Yet, while some investors might argue that price/earnings multiples are too high and common shares are expensive, the facts remain that:

- Interest rates are at generational lows making selective common stocks paying 3-5% dividend yields with capital gains potential very attractive.

- Non-resource corporate earnings results have been generally quite respectable with many companies increasing dividends, buying back stock and/or strengthening their balance sheets.

- The U.S. economy continues to improve despite some winter weakness whereas the Canadian economy is bouncing back from a first half 2015 decline.

During most of 2015, investment analysts and portfolio managers have had to tough it out as they have been bombarded with incessant stock price volatility and poor investment psychology. Moreover, 2015 investment performance for the first nine months has been negative for all North American market indices and, understandably, clients are grumbling and are quite critical. Consequently, during difficult stressful periods many investors are inclined to stand pat and to do nothing. They simply want to ride out the storm. However, by deliberately remaining inactive, investors often forgo opportunities to upgrade portfolios, to purchase deeply undervalued stocks and to liquidate underperforming securities. Clearly, tough people will make difficult investment decisions during these troublesome times although they will be severely tested and second guessed. Despite "the heat" they tend to be impervious to this criticism believing that patience, discipline and focus will prevail during these tough times.

In summation, there is no argument that we are in extremely confusing and tough times. We believe that the present period will lead to economic resurgence and improved common share prices. We will tough it out. While it hasn't been easy we believe that the eventual rewards will be well worth the wait.

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Economic Perspectives

Recuperating North American Economies

The Q2/2015 U.S. GDP was revised upward from a 2.3% growth rate to 3.7%. This revision was due to a number of factors including: increased business inventories, greater research and development spending, rising commercial construction, expanding employment, lower gasoline prices and greater household consumption. Also, due to previously subdued growth, there was probably substantial pent-up demand for goods and services which should portend continued economic activity, albeit, at a more moderate pace. With regard to Canadian GDP, the negative first half 2015 performance has been viewed as a short-term technical recession. More importantly, we are now starting to see positive signs of economic recovery in the second half of 2015. Furthermore, since Canada is an important marginal supplier of goods and services to the United States, any further American growth in employment and business activity should positively impact Canada. Overall, we believe that the recuperating North American economies should be quite positive for U.S. and Canadian common stock prices.

Investment Perspectives

Selectively Picking Stocks

The inordinate stock market volatility while unsettling to many investors is providing periodic occasions to acquire stock positions at opportunistic prices. For instance, with extreme investor emotions and subdued volumes, many stocks are trading with wider daily high and low price bands. Although there may be nothing fundamentally wrong with these stocks the uncertain market place is creating attractive points of entry. In fact, one is often reminded that while common stock prices may vary company valuations generally do not change dramatically. As a result we are selectively picking common stocks to be added to our portfolios and are patiently awaiting the opportunity for their purchase.

Portfolio Perspectives

Continuing Our Diversification

As we enter the last quarter of 2015 we continue to diversify our portfolios into our favoured sectors including healthcare, technology, consumer discretionary and special situations. We have added new holdings and sold out completely or trimmed certain positions. During the third quarter we have purchased a number of American stocks while maintaining our $U.S. currency hedge to protect our American dollar investments. Among our U.S. purchases include: Aetna Inc., CVS Health, First Republic Bank, SAP SE, Express Scripts, Synopsys Inc., Electronic Arts, Honeywell International Inc., Skyworks, Becton Dickenson, Anthem Inc., and Home Depot. We have sold and/or trimmed SP Plus, American Express, Kansas City Life, Timken Co. Bed Bath and Beyond, Qualcomm Inc., The Gap, Industrias Bachoco, Micron Technologies and Viacom Inc.

ABC FUNDS

Five Favoured ABC Canadian Common Stock Holdings

Over the past year we have transitioned our ABC Funds towards increased U.S common stock exposure. We are, however, still quite positive on a number of our Canadian common share holdings. The highlighted five ABC Fund favourites have solid balance sheets, are free cash flowing, pay dividends, have relatively low price earnings multiples and remain undervalued. They include:

Echelon Financial Holdings: is a TSE-listed property and casualty insurance company primarily concentrated on non-standard automobile and specialty insurance products in Canada and Northern Europe. The company is debt-free with excess capital of approximately $25 million, is trading below book value and has just renewed a normal course issuer bid to repurchase up to 10% of its public float over the next 12 months.

Equitable Group Inc.: is a Toronto-based financial services company providing residential home mortgages, guaranteed investment certificates, commercial lending and securitization via its Equitable Bank subsidiary. The company has experienced and able management, pays a 1.25% dividend yield, trades at a price earnings multiple under 8.5 times and has continued to demonstrate very strong earnings growth.

Exco Technologies Ltd.: is a Markham, Ontario-based global developer, manufacturer and supplier of dies, moulds, equipment components and related products primarily to the automotive industry. Operating with facilities in Canada, the U.S., Mexico, South America and Asia, Exco is profitable, free cash flowing, dividend paying, debt-free and is “continuing to be vigilant regarding potential tuck-under acquisitions which bolster or complement our core capabilities.”

Stingray Digital Group Inc.: is a Montreal-based digital and entertainment services company supplying music programming globally. Benefiting from mostly Canadian dollar costs and U.S. dollar revenues, Stingray has high recurring revenue, an acquisitive growth plan of action, increasing cash flow and a dividend yield of 1.7%. The company is concentrating most of its expansion efforts outside of Canada with its primary focus in Europe and South America.

TransForce Inc.: offers transportation and logistics services, parcel delivery and fleet management assistance. Benefiting from low fuel costs, Transforce pays an attractive 2.6% dividend yield, is free cash flowing and has a normal course issuer bid in place for share repurchases. With a market capitalization of $2.5 billion TransForce is utilizing free-cash flow to pay down debt, repurchase its shares and to pay dividends. There is increasing speculation of a potential sale of the company’s Waste division, which if transacted, could become an important positive catalyst for TransForce’s common shares.

Foot Locker Inc.

Foot Locker is a leading global retailer of athletic shoes and apparel. The company operates 3,423 retail stores across 23 countries in North America, Europe, Australia and New Zealand under brands including Foot Locker, Champs Sports, Kids Foot Locker and Lady Foot Locker.

Foot Locker is an attractive investment for numerous reasons. Firstly, the company commands a leading position in the athletic apparel market, which is growing significantly faster than the overall retail sector. In particular, Foot Locker is seeing strong growth within its dominant footwear niche, benefiting from the growing popularity in basketball and running shoes. The success of Nike and its accompanying brands such as Jordan and LeBron continue to drive traffic to Foot Locker stores.

Additionally, the company has excellent management with a strong record of annual growth in both sales and net income. Since 2009, sales and net income have grown at an 8% and 44% rate respectively, expanding sales from $4.9 billion to $7.2 billion and net income from $85 million to $522 million. The company has grown revenue and profitability over the years through strategies such as increased customer focus, aggressive brand expansion, improved asset productivity and investing in high-potential business segment opportunities.

We believe that the company's superior execution will continue well into the future in conjunction with its 2015-2020 strategic goals. Foot Locker plans to grow sales from $7.2 billion in 2014 to a target of $10 billion in 2020, and to increase profitability through greater productivity per store, higher net income margins and lower costs. Management plans to expand sales and margins of the core business through numerous initiatives including: new store remodeling programs, improved marketing that will incorporate digital promotion and social media, as well as leveraging existing strength in basketball and classic shoes.

In addition to the core business, management has identified five key growth areas that will lead to continued sales improvements over the next five years: Kids, European expansion, apparel, digital business and women's merchandise. Foot Locker intends to grow their Kids business globally and drive a full-family experience by building connectivity with parents. The company plans to aggressively grow their European business through several initiatives, including: expansion in countries where they don't have sufficient penetration, focus on greater apparel sales and an increased digital footprint. The company expects their women's business to play a more significant role by developing a primary women's brand. Lastly, management wants to drive digital sales by investing in technology platforms and creating a more engaging digital experience.

Foot Locker is in excellent financial condition with a very clean balance sheet which positions the company for expansion. Holding roughly $970 million in cash on the balance sheet with only a small amount of debt allows management to pursue its growth strategies as well as to return cash to shareholders. Capital expenditures are expected to average $225 million per year with an anticipated 50-60 net new stores annually. More importantly, we like that the company generates significant cash flow, with a number of analysts expecting at least $500 million in free cash flow this year and in 2016.

Lastly, Foot Locker is committed to rewarding shareholders with both dividends and share buybacks. The stock pays a $0.25 quarterly dividend, providing a 1.45% dividend yield and we expect continued annual increases. Furthermore, the company has a share repurchase plan in place, with $1 billion of stock repurchases authorized through January 2018. In addition to the capital returns, Foot Locker shares have an attractive valuation. For instance, in calendar 2016, analysts expect the company to earn $4.69, giving a very reasonable price earnings ratio of 15 times. In summary, we see great potential in Foot Locker as it is a dominant company in a strong segment of retail sales and trades at an appealing valuation.

H&R Block Inc.

H&R Block is a financial services provider that specializes in tax preparation, accounting and consulting solutions, as well as personal productivity software. The company is the world's largest consumer tax services provider, which caters to one of the two inevitable phenomena that citizens of the developed world cannot escape, "taxes". Not only does H&R Block represent a compelling valuation, but the company has exhibited impressive catalysts and a promising outlook due to the inelastic demand for its services.

H&R Block is an attractive investment opportunity for the ABC Funds for several reasons. Firstly, the company has a compelling valuation as it is trading at a forward price to earnings multiple of 16.0x. Moreover, we believe that H&R Block has a free cash flow yield of approximately 5.0%. It is our opinion that the company represents substantial value due to its business model and reputation. The company has successfully grown its earnings over the past five years and revenue has been steadily increasing over the past three years. Despite the company's business sector being less flashy than a lot of other public companies' industries, H&R Block trades at an attractive valuation and has continued to grow both its top and bottom line.

Secondly, H&R Block's tax services segment is a leader in its niche and provides a significant amount of cash flow from operations. Since the company has very little requirements for maintenance capital, H&R has directed its excess generated cash to fund its 2.3% dividend yield and the company's share buyback plan. Considering the assets and reputation of H&R Block are high quality and that its revenue should grow with the U.S. economy, we believe that the company offers good value in this market.

Thirdly, the company announced a positive, material change to its business structure; on September 1st, the company reported that it successfully closed the transaction to divest H&R Block Bank, its banking segment. This action allows the company to completely focus its efforts on its core tax business and will make H&R less complicated to analyze. Furthermore, the company will no longer be regulated as a savings and loan holding company. Of great interest was H&R Block's announcement that it intended to establish a new capital structure, which included a $3.5 billion share buyback plan over the next 4 years. On October 8th, the company announced that through a "Modified Dutch Auction" tender offer, the company spent $1.5 billion to purchase approximately 40.5 million shares at $37 per share. This purchase represented approximately 14.7% of H&R Block's common shares outstanding as of the end of September. The company's goal is to significantly increase its return to shareholders through dividends and common stock repurchases. It is our opinion that the company's strategic action of divesting its banking segment and materially rearranging its capital structure represents a significant corporate change. We believe that this should evolve into an important corporate driver and could position H&R Block as an attractive takeover candidate

Finally, H&R Block exhibits a very strong balance sheet and solid business fundamentals. As of September 30th, the company had long term debt of $500 million, which was dwarfed by its market capitalization at the time of approximately $9 billion. When we purchased the common stock of H&R Block, it was our belief that the company could benefit by leveraging the balance sheet by either making a strategic acquisition or buying back its undervalued common stock. When H&R Block announced the divestiture of its banking segment and highlighted its new capital structure plan, it awakened investors to a more aggressive business approach. In addition, the company indicated that it could increase its adjusted debt to EBITDA ratio up to 2.5x. Next, on September 21st, H&R Block announced a new credit facility of $2.0 billion, replacing its previous line of $1.5 billion. Considering the strength of H&R Block's balance sheet, business fundamentals, and free cash flow, we believe that the company should be able to fund future share repurchases, dividend increases, and potential acquisitions.

In conclusion, H&R Block's business model may lack the flashiness and intrigue of other companies, but its valuation, business model, new capital structure, reputation, and cash flow make the investment very intriguing. A stronger U.S. economy, better U.S. employment numbers, and the company's intent to return cash to shareholders represent significant catalysts for share price appreciation over the next few years. Lastly, considering H&R Block's initiative of focusing on its core tax services business and the redesign of its capital structure, we believe that H&R Block represents a solid investment for these frenetic times.

ABC FUNDS

Focus on Fundamentals

> **"Without the fundamentals**
> **The details are useless"**
>
> **-James Clear**

Given the extremely distracting and, often times, irrelevant financial and political news flow confronting the markets it is not surprising the difficulty of many investors to concentrate on individual company fundamentals. Furthermore, combined with the extraordinary market volatility over the past several months stock picking has become even more challenging and has precipitated considerable investor hesitation and inaction.

Notwithstanding the present market confusion and variability we continue to focus diligently on specific companies and industry fundamentals. In fact, in our pursuit of undervalued common stocks we have continued to spotlight such essential factors including: free cash flow, low price earnings multiples, dividend yields, consistent earnings growth, experienced and able corporate management, potential positive share price catalysts, stepped-up company replacement values as well as Canadian production costs with higher valued U.S. dollar revenues. A few specific Canadian examples of ABC stock selections based on these investment parameters include: Exco Technologies, Stingray Digital and UniSelect Inc. With regard to appealing industries we continue to favour the U.S. healthcare industry (e.g. Aetna Inc., Becton Dickinson, Boston Scientific and CVS Health Care), consumer discretionary retailers and service providers (e.g. Carriage Services, Cheese Cake Factory, Foot Locker Inc., and Home Depot) and high technology leaders (e.g. Avago Technologies, Google Inc., and Mentor Graphics).

In spite of the present market volatility and lack of price consistency we believe that our primary focus on fundamentals will serve our portfolios and clients very well over the balance of 2015 and into 2016

Irwin A. Michael, CFA

Administrative Information

· All cheques are to be made payable to RBC Investor Services.

· All client requests are to be directed to ABC Funds.

· There are units of the ABC North American Deep-Value Fund & ABC Dirt-Cheap Stock Fund available for purchase. Contact our office for more information.

· We continue to request that clients assist in updating their "Know Your Client" forms. This information is a regulatory requirement to assess the suitability of our various ABC Funds to individual client's needs.

· Purchase requests must reach our office by the last business day of the month and redemption requests (for our open funds) must reach our office no later than ten business days before the last business day of the month. Our closed-end funds have their own liquidation options. Please contact our office for more information.

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