

# Sionna Diversified Income Fund

## Fund Commentary

The S&P/TSX Composite Index was up 3.7% this quarter on a total return basis.

The financials and energy sectors were the main contributors to the Composite's positive performance this quarter. The financials sector benefited from the banks strong performance as a group. West Texas Intermediate (WTI), the benchmark for North American light crude oil, increased 12.2% to close at US\$52 per barrel – this contributed to the energy sector's positive performance.

During the quarter, the Sionna Diversified Income Fund underperformed its blended benchmark (75% S&P/TSX Composite Index and 25% Barclays Capital Intermediate Credit Index (Hedged)).

## Positive Contributors

Finning International Inc (Finning) was a positive contributor this quarter. The improvement in its share price was driven by improved prospects related to mining and oil and gas capital expenditures. Sionna believes Finning has made significant adjustments to its cost structure during

the recent energy downturn and is well positioned to deliver strong earnings once volumes recover.

The Fund's position in AutoCanada also added to performance. The company is the only publicly traded auto dealership in Canada, and possesses an attractive business model that is anchored by a steady parts and service business. Despite this, the company has faced some difficult times recently due to their high geographic exposure to Western Canada, Alberta in particular. Fortunately, auto sales in Alberta appear to be recovering, which should lead to improved profitability for AutoCanada. The market has realized this, and the stock has recently appreciated.

Canadian Western Bank was another positive contributor to performance this quarter. Canadian Western Bank is a traditional bank focused on commercial lending in Western Canada. It is predominantly a traditional lender and has benefited from the recent increases in interest rates. It has a history of prudent lending, maintaining a low-cost structure, a steadily growing loan book and having lower loan losses than its peers. Almost 40% of Canadian Western Bank's business is in Alberta, which has led to a volatile

stock price amidst fears that continued economic weakness in the region could lead to higher loan losses. Despite its geographic exposure, Canadian Western Bank continues to perform well and grow outside of Alberta, which has benefited the company. The improved oil price outlook also helped the stock's performance over the quarter.

## Performance Detractors

The fund's position in Boardwalk REIT (Boardwalk) detracted from performance. Boardwalk owns apartment buildings across Canada, with most of the portfolio in western regions of the country. The energy downturn and related economic weakness has negatively impacted these assets, leading to lower rents and reduced occupancy levels. The company is focused on investing internally to improve the quality of its rental properties and to better position the business for when the operating environment improves. Boardwalk's cash flows have been declining, putting pressure on distribution payout ratios, and its share price has been weak. Boardwalk continues to have quality assets and a strong management team that is well aligned with shareholders.

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Computer Modelling Group (CMG) was a negative contributor to performance this quarter. CMG develops and sells reservoir simulation software to oil and gas companies. As the availability of easy-to-extract oil declines and production from unconventional supply sources increases, demand for CMG's products is expected to rise. The company is a dominant player in a niche market, with an excellent performance history, high margins, strong cash flow and no debt.

Pason Systems Inc. (Pason) was another detractor to performance. Pason is an energy services company that is the dominant player in the drilling rig instrumentation market. Recently, the stock was a negative contributor to the portfolio despite improved financial performance in a volatile energy market environment. Pason is a well-managed business with a dominant market share (more than 50% in the U.S. and more than 90% in Canada). Its products represent a small cost to the end customer, yet are critical to operations. Sionna remains happy with their investment in the company.

## Select Buy & Sell Activity

The Fund exited its position in Ensign Energy Services Inc. (Ensign) this quarter. Ensign is a contract drilling company with operations in Canada, the U.S. and international

locations. The drilling business is a competitive and cyclical one, but Ensign's management team has a history of prudently managing the company. The company is very focused on costs, which has served the company well during downturns, and the management team has often made counter-cyclical acquisitions using its strong balance sheet. However, the energy industry has been transformed in recent years. The increase in new types of reservoirs has changed the requirements for drilling equipment. Ensign has always maintained a conservative approach to rig renewal, leaving the company with an inferior fleet of rigs and lost market share. While the company's shares continue to trade below Sionna's estimate of intrinsic value, the value of the underlying business has declined over the years. Over time, Sionna has been reducing their position as the shares approached their revised estimate of intrinsic value and have now exited their position.

The Fund also eliminated its position in Power Corporation (Power Corp) in the third quarter. Power Corp is a holding company that derives most of its value from investments in the asset manager IGM Financial and the life insurer Great-West Lifeco. Sionna believes that both IGM and Great-West Lifeco are good-quality, well-managed and conservative companies. However, they are less clear about the value of some of the investments at the holding company level, where excess capital has been invested in private

investments that are more difficult for shareholders to evaluate.

## Current Positioning

The market was relatively quiet this quarter as many buyers and sellers of stock were on holiday. Quiet is good, but the type of quiet that lulls you into complacency is not. Just last quarter Sionna talked about investors being skittish. Yet with fewer sensational headlines in recent months, the market was quieter and less excitable. Sionna doesn't mind this. In the U.S. however, they are noticing some signs of complacency.

For the decade since the financial crisis, investors and commentators have talked ad nauseam about the impending "correction" in the U.S. However, the U.S. market has relentlessly marched upwards causing some investors to relax and increase their tolerance for risk. A couple of headlines recently caught Sionna's eye: "Good Reasons to Dismiss Market Fears, For Now" by the former CEO and Co-CIO of the giant bond manager PIMCO, and "Pressured Pensions Target Riskier Assets" in the Wall Street Journal.

When the market is complacent about risk management, Sionna's guard is up and their not alone. The well-respected

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investor Howard Marks of Oaktree Capital reacts the same way. In his most recent letter to clients, he lamented that the market is once again exhibiting “pro-risk” behaviour. This is especially worrisome at a time when assets are expensive and prospective returns are low, causing large investors such as pension funds to “reach for return” – a very dangerous game. He cited several observations of this “pro-risk” behavior.

So what is an investor to do? First, it's important to acknowledge that there is always danger lurking in the background, regardless of where we are in the cycle. Vigilance is as important during troughs as it is during peaks. Second, Sionna are believers that it's almost impossible to time the market; they can't think of any investor who repeatedly profited by doing so. Third, it is important to stay invested; substantially raising cash, unless the circumstances are extraordinary, can act as a considerable drag on long-term results.

It's true that equities appear expensive in the U.S. It's important to note, however, that the low interest rate is driving up asset prices and history doesn't offer guidance to what fair value is in this type of environment. In Canada, the market seems even less extraordinary. The TSX

Composite is trading at 17 times trailing earnings, which is only moderately above historical norms.

A quiet market can lull investors into being complacent about risk. Appropriately, the investment team consists of worrywarts, Sionna is vigilant even when (and especially when) the market is quiet. They've written about how they “stick to our knitting” through market gyrations before – this time is no different. They'll continue to consistently apply their investment process whether the market is quiet or loud.

## About Sionna

Founded in 2002, Sionna is an independent, value investment firm with over 80 years of experience shared among its portfolio managers. Sionna believes that value investing is a craft. It takes discipline and patience and it is the foundation on which Sionna has grown. As an independent firm, Sionna runs its business with clients' best interests in mind and takes a long-term view with focus only on companies that it believes will help compound its clients' capital.

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## Contribution Analysis (relative to benchmark)

LAST QUARTER				LAST 12 MONTHS			
INDUSTRY		INDUSTRY		INDUSTRY		INDUSTRY	
Top 5 Contributors	%	Top 5 Detractors	%	Top 5 Contributors	%	Top 5 Detractors	%
Banks	0.42	Equity Real Estate Inv. Trusts	-1.21	Oil, Gas & Consumable Fuels	3.29	Investment Funds	-1.85
Trading Companies & Dist.	0.37	Investment Funds	-0.73	Metals & Mining	1.99	Media	-1.82
Specialty Retail	0.36	Software	-0.39	Electric Utilities	0.83	Equity Real Estate Inv. Trusts	-0.96
Transportation Infrastructure	0.28	Chemicals	-0.20	Capital Markets	0.46	Banks	-0.56
Food & Staples Retailing	0.25	Insurance	-0.13	Trading Companies & Dist.	0.45	Commercial Services & Supplies	-0.39
COMPANY		COMPANY		COMPANY		COMPANY	
Top 5 Contributors	%	Top 5 Detractors	%	Top 5 Contributors	%	Top 5 Detractors	%
Finning International Inc.	0.41	Boardwalk REIT	-1.14	Brookfield Infrastructure PA	0.77	Brandes Corporate Focus Bond Fund	-1.88
AutoCanada Inc.	0.35	Computer Modelling Group Ltd.	-0.44	Prairiesky Royalty Ltd.	0.66	Aimia Inc	1.83
Canadian Western Bank	0.29	Pason Systems Inc.	-0.18	Finning International Inc.	0.53	Boardwalk REIT	-1.46
Westshore Terminals	0.28	Canadian Natural Resources Ltd.	-0.17	Canadian Western Bank	0.49	Manulife Financial Corp.	-0.60
PrairieSky Royalty Ltd.	0.28	CI Financial Corp	-0.15	Granite Real Estate Inc.	0.38	Canadian National Railway	-0.43



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