SAGE PAGE

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2016 is looking like a particularly good time to play it SAFE.

Before we get into the details, let us state, it is possible to make money during adverse times. 2015 was no walk in the park, yet our SAGE equity model was up 16.84% to 11/30/2015. And we accomplished this by playing it safe – with a beta of 0.35.

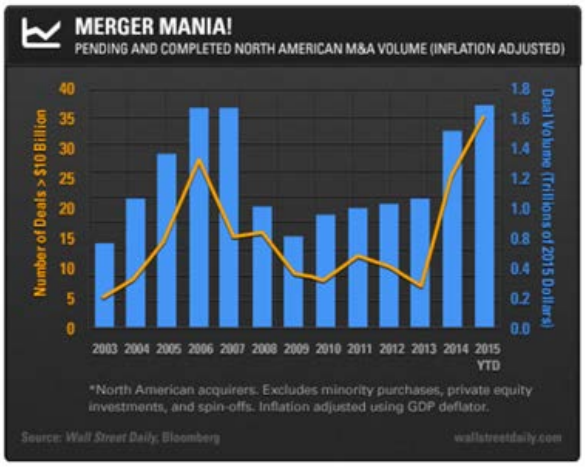
2016 will be more volatile than previous years for these seven reasons:

1. EARNINGS RECESSION "Every five to seven years investors forget there is a recession every five to seven years". Our chief investment officer, David Sherlock, coined this phrase about one year ago, and since then we have been positioning ourselves accordingly. We share this quote again as this expansionary phase is getting long in the tooth. On March 9, 2016 it will be seven years old.

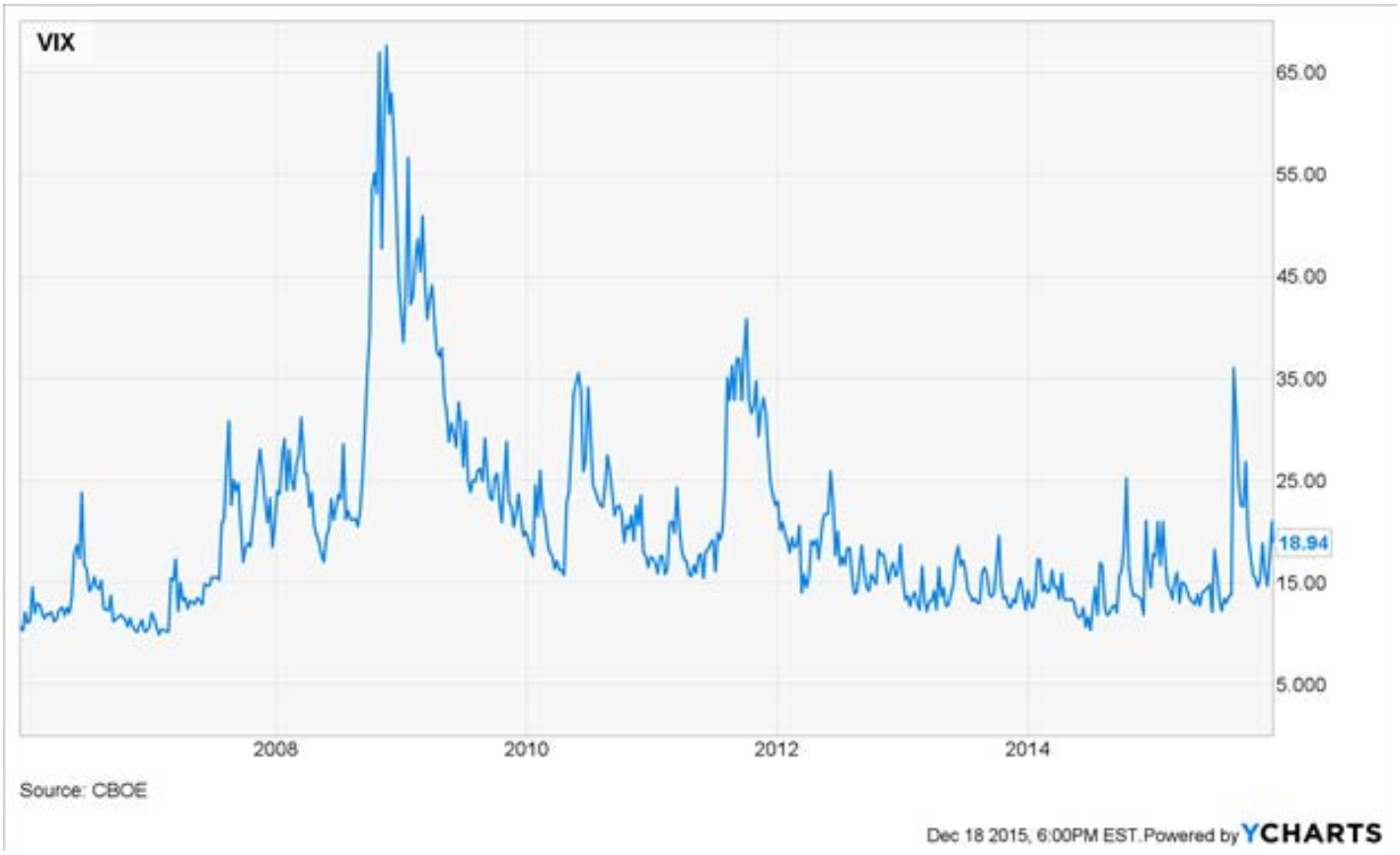
2. REVENUE AND EARNINGS CONTINUE TO SLOW. For the first time since the 2009 market bottom, we suspect 2016 will see margin growth slow, stop and turn negative. Without the originally expected 2016 earnings per share ("EPS") growth of 8.00%+ in the US, price to earnings ("PE") multiples could fall from their current levels of close to 21x EPS down to 18x.

3. INCREASED MERGERS AND ACQUISITIONS This is a typical late cycle activity for companies as their organic sales growth and profitability slows. They strive to overcome this shortfall by pursuing growth through acquisitions. This has already started to pick up as you can see from the chart below. During this phase, volatility rises as investors speculate on which company will be the next takeout target. That speculation starts to trump attention on corporate performance. This becomes a game of chasing pennies with dollars. A game that never ends well.

4. INTEREST RATE POLICIES IN NORTH AMERICA. Since 2009, the US Federal Reserve ("Fed") has 'printed' trillions of dollars with its quantitative easing initiative. This record amount of liquidity inflated stock market valuations but did not trigger inflation. In fact, deflation is still a much bigger threat than inflation. Despite this scenario, the Fed went ahead with an interest rate increase on December 16, 2015. In our view, this move was done more as an act of saving face and credibility than necessity.

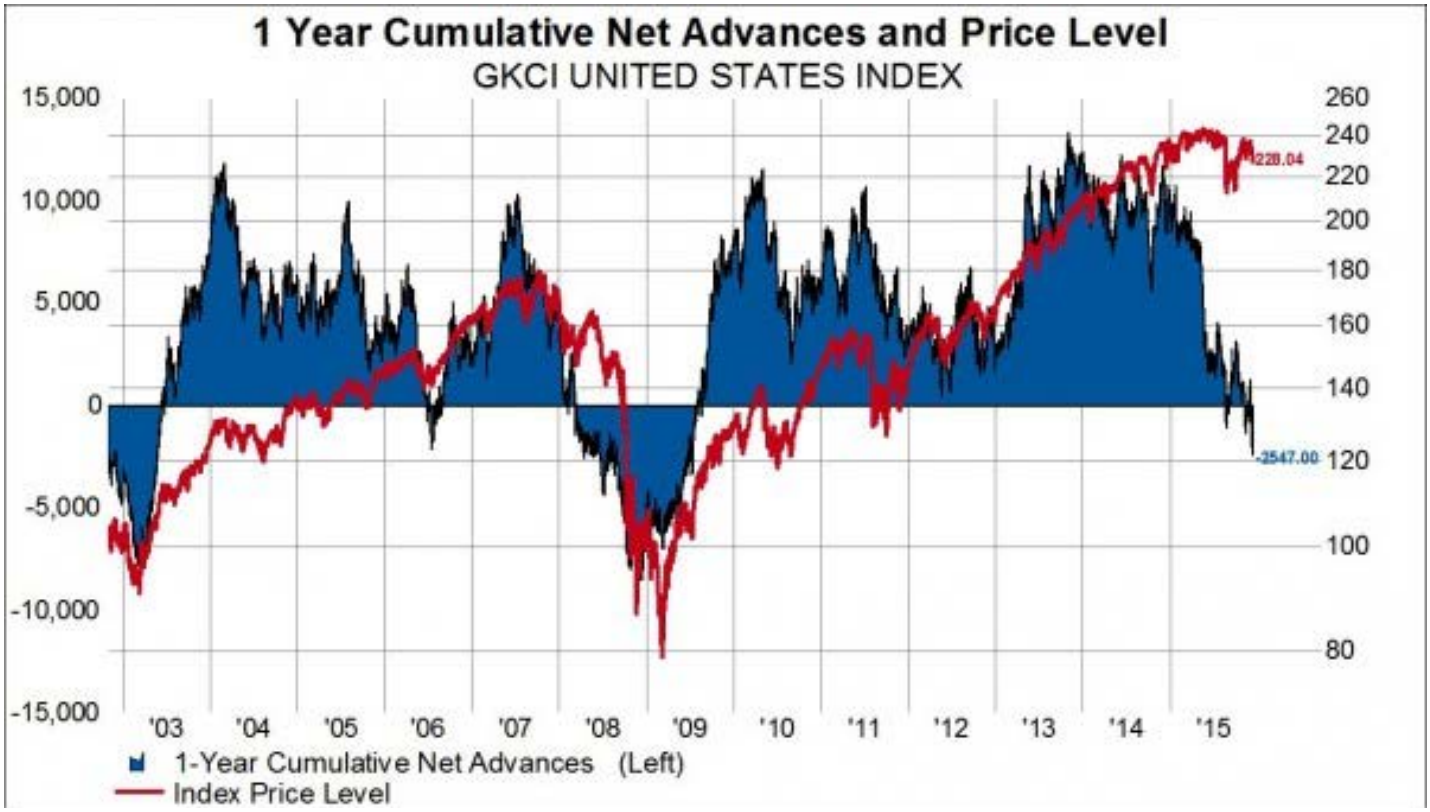


5. VOLATILITY BELOW HISTORICAL AVERAGE. The CBOE Volatility Index ("VIX") represents one measure of the market's expectation of stock market volatility over the next 30-day period. You can see in the chart below, aside from the little blip in August of 2015, the VIX has not spiked since 2012. Furthermore, levels of equity volatility appear to be below the volatility levels of other asset classes.



6. GEOPOLITICAL RISK: OIL, ISIS and GOVERNMENT POLICY ERRORS Emerging and resource extractor countries will continue to destabilize as commodity prices remain low, increasing the possibility of political uncertainty and acts of terrorism. These risks include increased tensions in the Middle East (e.g., between Russia and NATO allies), increased risk of terrorist attacks in the US and Europe, as well as strains in the eurozone related to the immigration crisis.

7. MORE STOCKS HAVE DECLINED THAN ADVANCED For the first time since 2009, more companies have declined than advanced. Net advances have fallen from 10,760 in January, 2015 to NEGATIVE 2,547 on December 15, 2015. See chart below.



This weakness is partially masked by the remarkable rise in the F.A.N.G. stocks: Facebook, Amazon, Netflix and Google. See chart below. Up 82.5% in 2015 – these 4 stocks added positive 32 points to the S&P500 Index which is down 60 points. They trade at ridiculous PE multiples: Facebook = 105; Amazon = 967; Netflix 312 and Google (renamed Alphabet) = 35.

HOW YOU CAN PROFIT IN A VOLATILE 2016.

Again, we want to emphasize that IT IS POSSIBLE TO PROSPER IN VOLATILE TIMES. Many of the issues identified above have been in play over the past year, yet our SAGE equity model grew by 16.84%. During times of increased volatility and uncertainty there are a number of opportunities to profit... many of them bear fruit in all seasons. Here is a quick explanation of the methodology behind SAGE's three pronged approach as it relates to the current market:

1. STOCK SELECTION:

The US' recent reversal of their QE initiative removes a crutch from stock prices. Going forward stock valuations will stand more and more on their individual merits. In this 'stock pickers market', it behooves investors to avoid investments that encompass the entire market. By owning the whole market you own the good, bad and the ugly – and the ridiculously over-priced FANGs. It is better to play it safe and only own the best of what is available. The SAGE equity model holds the 40 best stocks according to our criteria:

a. High return on equity…our model's average ROE = 32.5%

b. Low price to earnings ratio…above we mentioned how the P/E multiples could contract from 21 to 18. The SAGE equity model holds have an average P/E multiple of 14.3.

c. Intransigent earnings quality. Companies that have generated great earnings despite market conditions. Sectors like: food, staples, utilities and healthcare.

By purchasing highly profitable securities trading at low valuations you are far less sensitive to negative earnings revisions and slowing growth. Better safe than sorry.

2. INVESTMENT ALLOCATION:

This is our attempt to optimize risk and reward by adjusting the percentage of each asset in the model according to the stock's price risk. Our two main considerations here are the volatility of the stock, relative to the market and relative to itself. From this information, we make the following adjustments:

a. Allocate more capital to less risky (low beta) stocks.

b. The lower the stock is within its price range, the more capital we allocate to it.

3. HARVESTING VALUE FROM VOLATILITY:

In times of volatility, investors tend to "throw out the baby with the bath water". They shun the stock market and sit on the sidelines. At SAGE, we have developed a trading process that mitigates risk and generates incremental profits over 'buy and hold' strategies. Critical to this process is the strength of the companies identified with our stock selection criteria.

As long as the earnings remain intact, large fluctuations in their stock price present opportunities to:

a. Trim the position when they trade significantly higher than their average price.

b. Add to positions when they trade significantly lower.

The more volatile the markets, the more often these opportunities present themselves. Execution of this repeatable process is the gift that keeps on giving.

Another consideration for volatile times is the FLIGHT TO SAFETY phenomenon. When investors get nervous about the world economy and geopolitics they move their wealth to safety. Today that means moving capital to the United States, selling down their local currencies to buying US dollars and US investments. Owning US investments acts as a good hedge in times of increased uncertainty and confusion. Further to our 'better safe than sorry' theme, avoid emerging and resource extracting countries. It is still too early to invest in capital intensive, highly leveraged, highly cyclical industries like oil and mining.

Please email us at: info.SAGE@raymondjames.ca or call 403-509-0569.

Wishing you a prosperous and joyful 2016.

Brad, David & Geoff

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