Signature Market Roundup

April 2014

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GLOBAL ASSET MANAGEMENT™

Global outlook

Drummond Brodeur
Senior Vice-President, Portfolio Management and Global Strategist

Compared to the past several years, the broad macro roadmap is looking decidedly BORING! There is no obvious economic crisis looming, financial systems are not collapsing, funding channels remain wide open, valuations are reasonable, fear has subsided but greed has yet to seize the day. Yes, Putin is throwing up some interesting political challenges and regional economies such as Venezuela and Argentina are collapsing. But none of this offsets the fact that the global economy continues to gradually heal and return to a more normal setting. Perhaps the biggest challenge is that after the adrenalin-inducing swings from one crisis to the next and the dramatic policy and political drama of the past seven years, we have forgotten what normal looks like. However, understanding the global macroeconomic picture remains essential.

The biggest macro challenge that will continue to play out over the year is the normalization of U.S. monetary policy and rate structures, with varied implications for asset classes and regions. Furthermore, many longer-term issues such as economic rebalancing and structural reform in Europe, Japan and the emerging markets have not been resolved and may resurface. But that is normal. It means that when it comes to markets, the top-down macro issues no longer completely dominate the bottom-up micro fundamentals. It may be less exciting, offer lower expected returns and volatility, but it's more normal.

As we enter the second quarter, the view we outlined at the start of the year remains intact: A synchronized global recovery led by the U.S., with the stronger U.S. outlook allowing the Federal Reserve to stay on a path of winding down its unconventional monetary policies, which have dominated global markets for the past five years.

While very little has changed in our full-year outlook, there have been a few surprise twists and turns. Far and away the biggest twist was the long and harsh winter across much of North America. It is irrefutable that the weather has significantly affected the economy but what's uncertain is how much of the impact is temporary and how much is reflective of a broader underlying trend.

As the weather improves, we expect – and are beginning to see – stronger economic data that will confirm the U.S. economy is snapping back from its first quarter lull. The challenge for the coming quarter is that the data may prove to be overly strong relative to the underlying growth trend as economic activity plays catch-up. This can matter to the markets. While longer-term expectations were not impacted by the first quarter economic slowdown, the U.S. bond market reacted. The U.S. 10-year bond yield declined to 2.6% from 3.0% during the quarter, even as the Fed made clear that it viewed the economic weakness as temporary and continued to taper its bond purchases. While we do not expect a significant rise in rates, we are wary of a potential spike higher should we see a string of stronger-than-expected economic reports in coming months.

Outside of that scenario, we expect U.S. rates to remain in the current range of 2.6% to 3.0% through mid-year until clear evidence of a sustainable pick-up in demand emerges, which is likely in the second half. We see the U.S. economy accelerating toward 3% growth in the second quarter, close to double that of the first quarter, which appears to be tracking close to 1.5%. We expect equities to continue to outperform, but at a more moderate pace than last year and with more of the volatility we saw in the first quarter. Our base case for the year is that markets can be expected to grind out a return in line with earnings growth of 8% to 10%.

Emerging markets

Matthew Strauss
Vice-President, Portfolio Management,
Portfolio Manager
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Hopes of a strong start in 2014 for emerging market equities quickly dissipated as a number of local developments roiled investor confidence: currency devaluations in Argentina, political instability in Venezuela; the Russian invasion of Crimea; falling commodity prices; disappointing economic data out of China fuelling renewed concerns about a hard landing; and the first high-profile defaults in China following a multi-year credit boom.

However, towards the end of the quarter, the impact of most of these events started waning. Encouraging news from China about its willingness to contemplate minor stimulus measures to ensure growth remains above 7%, together with positive political developments in a number of countries (India, Indonesia and Brazil) prompted investors to move back into emerging market equities. The overall index rallied 3.1% in U.S. dollar terms in March, outstripping its developed market peers by almost 300 basis points. The resilience of emerging market equities despite an onslaught of negative news in the first quarter might well be indicative of a market that is starting to price in most of the shocks.

Going into the second and third quarter of 2014, higher U.S. bond yields remain one of the primary risks to emerging market assets. Partly offsetting this is the sharp learning curve that emerging market central banks underwent since the shock in May 2013, when comments by U.S. Federal Reserve Chairman Bernanke were interpreted as the first signs of reducing monetary stimulus. Back then, emerging market central banks were slow to react to the subsequent capital outflow following these comments. However, as seen in January, central banks are now much quicker to defend "financial stability."

Trying to time the exact turn in sentiment towards emerging markets is laden with pitfalls, but we are becoming more constructive towards this asset class following the first quarter. Returns will continue to differ significantly between the various emerging markets with domestic factors playing an important role in driving returns. Encouraging signs over the next six months would include: reduced political uncertainty in India, South Africa, Indonesia and even Brazil; the realization that there will be fewer disappointing economic growth reports; risks of a hard landing risks in China being replaced by steadier growth (although concerns about leverage and property should keep unbridled bullish sentiment in check); and clearer earnings visibility.

As risks dissipate, countries with the biggest macro upside seem to be India (politics and hope of reforms) and Mexico (reforms and the benefits of the U.S. economic recovery), as well as the Philippines and Colombia. Despite cheap valuations, politics and economics are still highly uncertain in Brazil, Russia and South Africa.

Financials

John Hadwen
Vice-President,
Portfolio Management
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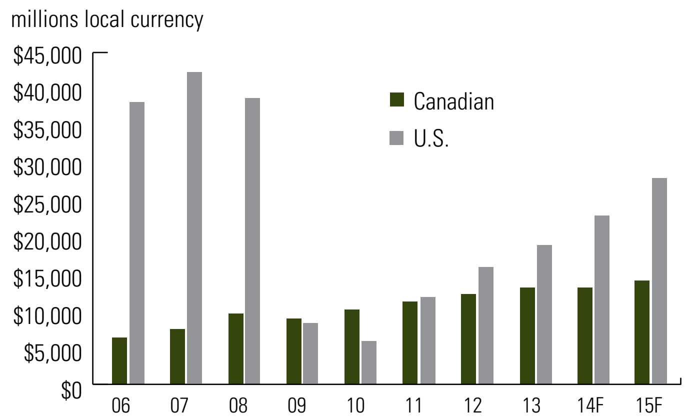
The early days of spring for global bank investors are all about DFST and CCAR. The Dodd-Frank Stress Test (DFST) and Comprehensive Capital Analysis and Review (CCAR) have become the binding capital constraints for the 30 largest U.S. banks. These exercises combine to ensure that they set dividends at levels that are prudently sustainable through a horrific financial crisis.

We have believed for a few years that large U.S. banks offered tremendous dividend growth from the extremely depressed bottom established in 2010 and that valuations would normalize from depressed levels as dividends increased. The dividend growth has lagged our previous expectations, as regulators have discouraged dividend payout ratios above 30%. However, the total payout ratio (stock repurchases and dividends as percentage of earnings) approved this year is 68% on average. The Federal Reserve is more comfortable with buybacks than dividends, apparently on the view that dividends are more difficult to stop in a crisis.

The chart illustrates how massive the dividend cuts were during the financial crisis and we have provided total Canadian bank dividends for additional perspective. The strong dividend growth at U.S. banks will be very supportive to valuations and help financials regain their importance within dividend mandates. U.S. bank dividends are expected to come in at $22.5 billion in 2014, 22% higher than in 2013. Approved stock buybacks for this group are also $22.5 billion. The $45 billion in combined dividends and buybacks exceeds the $42 billion in dividends this group paid out in 2007.

Citigroup was penalized in the CCAR. It did pass the "quantitative" stress test easily, coming out ahead of other large U.S. banks, but it failed the "qualitative" test. The bank was told to improve its reporting and oversight structure. However, we believe this only delays the inevitable and that plenty of capital will come back to shareholders over time.

Combined dividends paid – large U.S. bank basket versus Canadian banks



Source: Signature Global Asset Management, Bloomberg

Scot Vali
Vice-President,
Portfolio Management
and Portfolio Manager

Cold.

That is the best description of this past winter season in North America. For the natural gas market, this year's "polar vortex" was the best-case scenario. While there is much discussion about proposed liquid natural gas (LNG) facilities, renewed petrochemical investments, power generation and other sources of future demand for North American natural gas, today's gas market is still driven by demand for heating and cooling. This will remain the case until 2018, when some of the above-mentioned sources of demand are expected to trickle into the market.

The recent cold weather led to record demand for natural gas for heating, drawing U.S. storage levels down to record lows (see Chart 1) of 833 billion cubic feet. Storage in Canada is similarly low, supporting front-month (or near-term) pricing and a contraction in the differential in prices for AECO or Alberta gas versus U.S. gas.

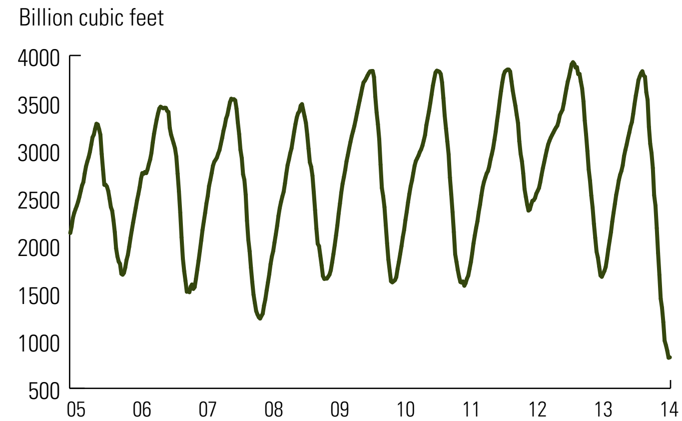
The current debate in the market revolves around the requirements to refill storage in preparation for next winter. Specifically, is there sufficient supply in the market or does the forward price of natural gas need to increase to incentivize new gas-directed drilling and/or switching to other fuel sources, namely coal? Most interesting, as the front-month prices have increased, prices for 2015 gas have remained depressed, failing to provide a signal to increase gas-directed drilling and resulting supply.

Today, the U.S. natural gas-directed rig count is at levels not seen since 1994, a full 80% below the peak reached in September 2008 (see Chart 2). This is occurring as companies are implementing restructuring programs to de-emphasize production of the very commodity that is currently in a shortage.

In the coming months, the pace of storage injections will be closely watched by market participants, as record injections will be required to return to normal storage levels of around 3.7 trillion cubic feet. Future price increases will further benefit the gas-focused exploration and production companies and the service companies they hire.

Chart 1: Natural gas inventories at new low

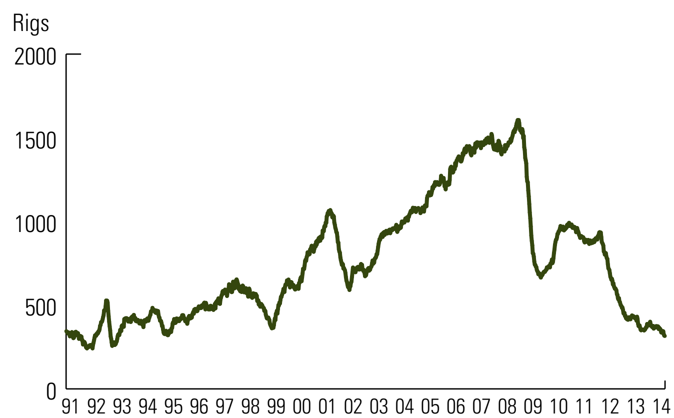
U.S. working natural gas in storage



Source: Bloomberg, U.S. Dept. of Energy

Chart 2: U.S. rigs drilling for natural gas at lowest level in 20 years

Baker Hughes U.S. natural gas rotary rig count



Source: Bloomberg, Baker Hughes Inc.

Consumer

Stephane Champagne
Vice-President, Portfolio Management, and Portfolio Manager

Consumer activity in the U.S. was weak in the first quarter of 2014, primarily due to severe weather in many areas. Retail sales in particular picked up in March as conditions improved. Off-price retailers, clubs and discounters continued to do relatively well, while department stores and specialty stores were impacted the most by the adverse weather. Retail activity in Canada was also affected by the harsh winter, while Europe was mixed, and Latin America and Asia remained subdued.

Overall, the S&P 500 Index outperformed the consumer staples index by 115 basis points and the consumer discretionary index by 450 basis points in the second quarter. The performance of the discretionary index reflected sluggish retail sales. The more defensive staples index accelerated after a weak fourth quarter, moving in line with the decrease in U.S. bond yields in which the 10-year U.S. treasury yield declined to 2.7% at the end of March from 3% at the end of December.

We expect the discretionary sector in the U.S. to improve in the second quarter to reflect improvements in job creation, housing and consumer confidence, which ticked higher in March. However, we believe Canadian consumption will remain slow with disposable income under pressure from reduced housing activity and high consumer debt levels.

In Europe, we continue to favour northern European and U.K. domestic-focused firms due to high unemployment in the southern regions of Europe. We are avoiding Eastern Europe and Russia due to the economic impact of the political instability in the region.

In Latin America, consumer fundamentals are likely to remain weak, especially in Brazil, where inflationary pressure and higher interest rates due to currency deflation are expected to limit discretionary spending in the first half of the year. We still favour Mexican and Andean consumer stocks that can benefit from positive structural reform and a more benign economic environment.

In China, consumption remained weak in the first quarter. A clampdown on luxury spending by government officials led to a significant drop in high-end food and alcohol consumption and affected results. Even though ordinary consumption is growing at a normal rate, we expect discretionary spending to remain under pressure in the second quarter. Headwinds for consumer confidence include tightening of credit access, slow housing activities, and potential banking reform. In the long term, we continue to be positive, as the rate of savings and disposable income remain high. In Southeast Asia, retail consumption is likely to remain weak due to interest rate increases and inflationary pressure resulting from currency depreciation experienced in recent quarters.

We continue to favour sectors supported by sustainable fundamentals, strong global brands, free cash flow generation, and return of capital to shareholders, led by share buybacks or dividend increases.

Health care

Jeff Elliott
Vice-President, Portfolio Management, and Portfolio Manager

The health care sector outperformed the broader markets in the first quarter, both globally (return of 6.0% compared to 1.4% for the MSCI World Index), and in the U.S. (5.8% compared to 1.8% for the S&P 500 Index), trailing only the utilities sector for total returns over the quarter. Despite a relatively steady performance from the sector as a whole, it was an eventful quarter for certain sub-sectors.

Large-cap pharmaceutical stocks performed well, despite concerns at the beginning of the quarter about their relatively high emerging market exposure. After a strong set of clinical trial results for the Big Pharma group, performance in the second half of the quarter was solid, further reinforced by the "flight to safety" observed in the broader markets.

Biotechnology and specialty pharma stocks were volatile, with strong performance in January and the beginning of February, which dramatically reversed over the second half of the quarter. The Nasdaq Biotechnology Index (which includes a number of specialty pharma companies) peaked in mid-February with a gain of 20% for the year-to-date, but closed the quarter up only 4.2% (and at the time of writing, was down 5% year-to-date). The apparent catalyst for the sell-off was a letter from lawmakers questioning Gilead's pricing methodology for its breakthrough Hepatitis C drug, Sovaldi. While we believe the letter will ultimately have little impact, it raised concerns in a sector that has seen tremendous outperformance over the past several years and is still not particularly well understood by generalists. Similarly, concerns over tax reform proposals rattled specialty pharma investors, who had enjoyed strong performance on mergers and acquisitions and "tax inversion" transactions. We were on the sidelines for both sub-sectors, with a lack of obvious catalysts to drive the stocks higher and stretched valuations leaving us cautious.

Health care service companies showed mixed performance, as stronger-than-expected enrolment under "Obamacare" dominated sentiment. This provided a tailwind for hospitals, since more insured customers means less bad debt expense, while managed care providers balanced the spectre of higher utilization with a potentially better mix of patients, as more young and relatively healthy people enrolled than had been expected.

Medical technology stocks performed essentially in line with the health care group, with procedure volume trends and Affordable Care Act enrolment updates providing a tailwind, tempered by weather-related concerns about utilization and some notable pipeline disappointments.

All in all, we maintain an overweight position in health care equities across our funds as we see significant longer-term tailwinds for the sector, with demographic and emerging market wealth effects driving strong demand for providers of health care. Our holdings remain biased to the large-cap pharmaceutical companies, which are experiencing improved fundamentals and beneficial product-related news.

In the other sub-sectors, we were more cautious as strong performance in 2013 had made valuations less compelling. The recent pullback makes the risk/reward profile more appealing, particularly in the biotechnology group, and we continue to look for opportunities in that space. We expect continued volatility in the health care services sub-sector given the uncertainty regarding the roll-out of Obamacare and expect any strength in hospital stocks to be transient given our longer-term concerns about reimbursement pressure from government and commercial payors. Similarly, we remain concerned about longer-term price pressures for medical device companies, given a relative lack of innovation potential. We are currently underweight these sectors.

Interest rates

Kamyar Hazaveh
Vice-President, Fixed Income

Rational exuberance

It is only rational to expect that after five years of unprecedented fiscal and monetary support, the private economy would be able to stand on its feet in a sustainable fashion. This was the hope for 2014, especially since there has been substantial improvement in the U.S. household balance sheets and the fiscal drag from 2013 has come to an end. However, the U.S. real GDP growth estimates for the fourth quarter of 2013 have been revised down substantially to the current estimate of 2.6%. Developed market bonds have outperformed as a result, with the U.S. and Canadian benchmark 10-year yields down by 0.45% and 0.30%, respectively, since the beginning of the year.

Cyclical divergence in an indebted global economy

The aggregate private and public sectors in the developed and emerging economies are more indebted today than in 2008 as policymakers have employed all tools to stop the deleveraging. Excessive debt limits the global growth potential. Current record low and falling levels of inflation together with muted wage growth are signs of weak final demand globally. It is within this over-indebted global picture that cyclical divergences among regions and economies are occurring. The United States and the U.K. have been able to deal with the aftermath of the crisis better than the rest of the developed markets and are enjoying relatively better cyclical growth.

Navigating a policy-driven market

Having exhausted fiscal policy bullets, major economies have relied on monetary stimulus to prevent further economic slide but their paths are diverging. The U.S. Federal Reserve under the new leadership of Janet Yellen is uneasy with the ever-increasing costs of unconventional policies and has been removing monetary accommodation since the end of last year. The Federal Reserve and the Bank of England have adopted "forward guidance" based on ambiguous output gap measures to guide short-end interest rates. The European Central Bank has been under tremendous pressure to do unconventional monetary easing as Europe edges towards deflation and the strength of the euro hurts exporters. The Bank of Japan under Prime Minister Abe is trying to change the perception of two decades of deflation in Japanese minds.

Outlook for bond yields, curve and spreads

In our valuations, the U.S. benchmark 10-year bonds are trading at the lower end of the range with fair value of about 3.15%. Given the divergent cyclical prospects in the U.S. and the U.K. relative to Europe and Japan, we are overweight the U.S. dollar and British pound.

On the curve, we have been overweight intermediate maturities (five to 10 years) at the expense of the long bonds (30 year). The risk-reward for extending duration risk to the long end of the curve is not attractive given our view for the major developed market central banks to be on hold for the remainder of the year. Our outlook for credit spreads remains generally positive and we are overweight spread products relative to the benchmark.

Foreign exchange

Matthew Strauss
Vice-President, Portfolio Management,
Portfolio Manager and Global Strategist

If the U.S. Federal Reserve's tapering was supposed to drive the U.S. dollar higher, it did not happen in the first quarter. Only two developed market currencies declined against the U.S. dollar during the quarter, but their weakness was more due to domestic concerns rather than broad-based U.S. dollar strength. The biggest underperformer was the Canadian dollar, with foreign investors becoming increasingly worried about the near-term economic outlook and implications for interest rates. Also, foreign inflows into the Canadian bond market slowed dramatically in 2013 and turned negative late last year. The Canadian dollar lost 3.9% against the U.S. dollar in the first quarter, far worse than the depreciation of the other major currency, the Swedish krona, which dropped by only 0.5%. Even compared to emerging market currencies, the Canadian dollar struggled during the first quarter, with only the Chilean peso (dragged down by a fall in copper prices) and Russian ruble (responding to the Ukrainian crisis) depreciating against the Canadian dollar.

Although the fall in the Canadian dollar was probably too aggressive during the first quarter, both domestic concerns and expected global developments, i.e., a gradual increase in U.S. Treasury yields, point to further weakness in the Canadian dollar against the U.S. dollar.

As a reminder of the sensitivity of currencies to changes in monetary policy, the New Zealand dollar turned in the best performance among developed market currencies after its central bank became the first major central bank to hike rates in this business cycle. The euro was almost unchanged against the U.S. dollar as the European Central Bank continued its wait-and-see approach, unwilling to signal any further monetary policy easing in the absence of severe disinflationary pressures in the Eurozone. Both the euro and Japanese yen are expected to weaken against the U.S. dollar during the remainder of 2014 as the central banks in both countries look at further monetary loosening, while the U.S. Federal Reserve continues to pave the way for the first rate hike in 2015 or early 2016.

Some of the weakest emerging market currencies of 2013 had a spectacular comeback in the first quarter of 2014 as investors gained guarded confidence that local institutions, most specifically the central banks, would proactively intervene in markets to prevent a repeat of the sell-off seen in May last year. The currencies of India, Indonesia and Brazil strengthened in early 2014 after a weak 2013.

Technology, media and telecommunications

Malcolm White
Vice-President, Portfolio Management, and Portfolio Manager

The global telecommunication sector was highly unpredictable in the first quarter, so much so we compared it to the NCAA Men's college basketball tournament aptly nicknamed "March Madness." This unpredictability was due to unprecedented regulatory changes and merger and acquisition speculation. In the U.S., the question is whether Japan-based SoftBank will take its investment in Sprint and use it to further consolidate the U.S. wireless space by purchasing T-Mobile U.S. France started off as a mundane situation where Vivendi, owner of the Société Française de Radiotéléphone (SFR), decided to spin off this troubled asset. However, this deal was intercepted by Patrick Drahi, a private entrepreneur and owner of French cable assets, who decided to take a run at SFR himself. France's other players, Bouygues Telecom and Iliad, swooped in to try to steal SFR away with a competitive offer, but Drahi ultimately prevailed with a sweeter bid. Mexico has undergone a major shakeup as regulators, fed up with the market dominance of Carlos Slim's Telcel, created a new regulatory body, IFETEL, to try and break up this quasi-monopoly. Europe, in contrast, is trying to decide whether it should be more relaxed on the regulatory front and permit market repair in Ireland and Germany by allowing rivals to consolidate.

Technology has been unpredictable this quarter for a different reason. The high beta names in the sector and the major outperformers from last year appeared to be on track for more gains this year. These returns peaked in mid-March with a very frothy level of record IPO issuance. But the situation has deteriorated since. While some de-risking has been due to the ongoing Russia-Ukraine situation, much of the volatility cannot be explained in the context of the underlying businesses, which are largely still on track. Hedge fund portfolio reallocations, high valuations and crowded investment strategies have been cited as reasons for the decline and we would agree with this assessment. Our preference this year, in contrast, has been for larger market-capitalization names that are under-owned and trade at a discount to the market multiple. Although the growth levels are lower, the volatility is also lower, which now looks like a better investment position.

Investment-grade corporate bonds

John Shaw
Vice-President, Portfolio Management, and Portfolio Manager

Investment-grade corporate bonds posted good returns in the first quarter, outperforming government bonds as interest rates fell and spreads tightened. Spreads tightened 12 basis points (bps) during the quarter and have tightened 25 bps over the past six months to stand at their lowest level since the financial crisis. Interest rates peaked as the fourth quarter ended, and fell in the first quarter due to reduced U.S. and Canadian growth expectations, rising concerns of a Chinese shadow banking crisis slowing growth, outflows of capital from emerging markets and increased geopolitical tensions as Russia took control of Ukraine's Crimean region.

The "great rotation" out of bonds and into stocks has yet to occur and the market has actually moved in the opposite direction in recent quarters. The strong performance in equity markets has increased demand for fixed income, especially corporate bonds. Large company defined benefit pension plans have enjoyed much better funding status on the back of higher equity markets and higher interest rates. Companies looking to reduce risk to their balance sheet due to their pension plans are shifting equities into bonds, which is another underlying reason for why any rise in interest rates is likely to be muted over the next year.

The outlook for investment-grade credit remains positive, as we believe that corporate bonds will outperform government bonds over the remainder of 2014. There is still money to be made in credit markets but it will certainly be smaller and depend more on specific credit events than the movement in the overall market. The North American and European economies are expected to pick up but any increase in interest rates is likely to be moderate, which are very good conditions for credit investors.

High-yield bonds

Geof Marshall
Vice-President, Portfolio Management, and Portfolio Manager

In the first quarter of 2013, the high-yield bond market tightened 36 basis points (bps) for a 2.9% return. In the first quarter of 2014, the high-yield bond market tightened 24 bps for a 3.0% return. Last May, Federal Reserve Chairman Ben Bernanke, taking comfort from improving economic data that suggested his massive monetary stimulus program was working, mused about tapering the quantitative easing. This set in motion a violent re-pricing of interest rate expectations that sent government bond yields 100 bps higher. The price on the U.S. 10-year Treasury bond dropped eight points and high-yield bonds shed two price points last summer.

With the taper underway since January of this year, there is now some nervousness in the market about growth sustainability, deflation, and potential policy mistakes. As such, government bonds yields are actually lower now than at the beginning of the year. We await data providing more clarity on economic growth excluding the impact of severe winter weather across North America. The data are likely to cause Treasury yields to rise, but not at the magnitude or speed of last year. If high-yield bond spreads can then act as a "shock absorber" in this environment and tighten as rates back up, returns should be in the mid-single-digit range. This will mean that returns will be much harder to come by, but hopefully will be less dependent on global risk on/risk off mood swings and more dependent on rigorous due diligence, individual bond selection, and default avoidance – a situation we look forward to. The below-average default rate in place since 2010 is not likely to increase materially until the business cycle turns to recession, which we believe is at least two to three years away.

Preferred shares

John Shaw
Vice-President, Portfolio Management, and Portfolio Manager

The Canadian preferred share market recorded its first positive quarter in a year on the back of falling interest rates and the large amount of redemptions. Interest rates peaked at the end of December and fell sharply in January due to concerns about economic growth in the U.S. and Canada. Government of Canada five-year bond yields declined 34 basis points to yield 1.7% at the end of the period. The BMO 50 Preferred Share Index posted a total return of 1.98% for the first quarter, while the lower-quality and broader S&P/TSX Preferred Index rose 2.7%.

The quarter was all about Canadian bank preferred shares. Firstly, the banks accounted for 85% of the $2.3 billion of redemptions in the quarter, with another $2.1 billion already announced for the second quarter. We expect an additional $2.5 billion to $3.0 billion in redemptions to be announced in the coming quarters. These redemptions are the result of new rules by the federal banking regulator that require the phasing out of old issues and their replacement by new preferred shares that can easily be converted into common shares should the regulator deem it necessary to save a bank. Secondly, the first of these new non-viable contingent capital (NVCC) preferred shares were issued during the quarter by Royal Bank, National Bank and Canadian Western Bank.

Issuance and redemptions in the quarter were fairly well balanced, but the list of announced redemptions for the second quarter is a strong tailwind for the preferred share market. This is especially true for highly rated bank preferred shares, as issuance has only been about 50% of the level of redemptions.

Our outlook for the preferred market is positive on the back of strong demand and falling supply, but following the solid performance in the first quarter and expectations for gradually higher interest rates over the course of the year, the total return for the BMO Preferred Share Index is expected to be in the range of 1.5% to 3% over the remainder of 2014.

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1404-0696_E (04/14)