PATHFINDER CORE: EQUITY & HIGH INCOME

We are pleased to bring you our Week in Markets for the week ending October 10, 2014. Markets have been increasingly volatile over the past few weeks which naturally has resulted in a more nervous sentiment from investors. This week we speak directly to our defensive strategy with the Core Portfolios and relay what we are doing to mitigate downside volatility. The Real Return Plus Fund breaks down the fund's strategy and asset mix in the current deflationary environment and we highlight Spectra 7 Microsystems Inc. (TSXv:SEV) in the Partners' Fund.

For the week ending: **October 10, 2014**			
Markets	**Week (%)**	**MTD**	**YTD**
MSCI World (US$)	-2.7	-3.9	-2.0
S&P TSX Composite	-3.8	-4.9	4.4
S&P TSX 60	-3.8	-4.8	5.0
S&P TSX Venture	-6.3	-9.0	-11.2
DEX Bond (iShare)	0.5	0.9	4.0
S&P 500 (US$)	-0.9	-2.5	4.3
Dow Jones (US$)	-0.8	-2.4	0.5
Russell 1000 (US$)	-1.0	-2.7	3.9
Russell 2000 (US$)	-2.6	-4.5	-8.2
FTSE (UK)	-2.9	-4.3	-6.1
Xetra DAX (Germany)	-2.1	-4.4	-5.7
Topix (Japan)	-3.1	-6.3	-4.5
MSCI EAFE (US$)	-2.4	-5.3	-8.7
MSCI Emerging (US$)	-0.7	-1.5	-1.3
Commodities	**Week (%)**	**MTD**	**YTD**
WTI: $85.77	-5.8	-9.3	-12.9
Nat. Gas: $3.85	-2.2	-7.4	-9.1
Copper: $3.03	1.1	-0.9	-10.8
Gold: $1,223	2.7	1.2	1.8
Baltic Dry: 963	-7.1	-9.4	-57.7
FX, Vol & Credit	**Wk (%)**	**MTD**	**YTD**
US$ DXY:85.9	-0.9	0.0	7.3
C$/US$: $0.89	0.4	0.0	-5.1
€/US$: $1.26	0.9	0.0	-8.1
€/¥: 136.0	-1.0	-1.8	-6.1
VIX: 18.8	16.1	17.4	36.7
CDS: NA IG 5 Yr	22.7	11.5	15.2
CDS: EU 5 Yr	17.3	11.6	-0.6
CDS: Japan 5 Yr	13.2	14.2	5.1
	3Mnth	**5Yr**	**10Yr**
US Treasuries	0.01	1.53	2.28

We have had a couple of conversations with clients this week regarding our thoughts on portfolio construction, given the way that the market has been reacting this fall. Canada in particular has been quite volatile with the run up in energy stocks this spring and the recent drop in crude over the past several weeks. Add in the strength in the US dollar since the beginning of September, and Canadian investors have definitely been "feeling it". In the Core portfolios, we have been cautious the whole way through. Thus, we missed the race up somewhat but have been protecting capital on the way down. Pathfinder clients know that this is by design. We prefer not to lose capital rather than to be fully invested and ultimately positively correlated with negative stock markets. This also allows clients to feel more comfortable blending in the Pathfinder Funds as appropriate. Right now our portfolios have 22-30% cash. We are also more than triple weight utilities stocks (defensive). We own a half weight in energy stocks and a third weight in financials stocks. Furthermore the stocks we own are the most conservative (lowest downside volatility in the sectors). The only place that we feel we have risk on in the portfolio is in our emerging markets stocks. While this has been volatile, it is a smaller part of the portfolio and can be liquidated quickly if we feel there are better opportunities, which tend to make themselves visible in stress situations.

We have tempered the portfolio because our previously constructive view on the global economy has changed, and at this point, we want to be different. With both volatility increasing and downside risk is a very real outcome; we believe that it is better to be positioned differently than the widely published benchmarks. To be different, our portfolios should not look like the average portfolio. We think we have them set up that way, but at the same time we have to be flexible enough to adjust this positioning. If the situation worsens then we will become even more different, and if it were to improve, we would need to normalize the portfolio based on a more constructive view.

PATHFINDER REAL RETURN PLUS FUND

Deflation in the last three months

We ended last week stating "we are assessing whether we have entered a momentary or prolonged period of deflation." Since June 30th we note the following in Canadian dollars: the cost of gasoline is down 16.2%, the cost of food is down 13.3% (FUD etf), and the cost of Canadian real estate is down 1.8% (Canadian REIT Index). Noting the above, it seems obvious that we have entered a momentary stage of deflation.

A momentary or prolonged period of deflation?

The challenging question is whether this is a momentary or prolonged period of deflation. This question is important because it drives asset allocation. 1. A deflationary environment drives us to cash and fixed income so that we can preserve capital while our cost of living falls. 2. An inflationary environment drives us to hard assets so that our capital can rise with the increase in our cost of living. 3. A deflationary environment with real growth drives us to invest in companies who incur revenue growth and margin expansion.

So we pose the question, will our cost of living be rising or falling in the future? A deflationary force is highlighted from our semi-annual report two editions ago: "What the ground-level American entrepreneur has accomplished over the last two years is a phenomenon we can only characterize as compounding innovation. Look at the innovation in energy completion methods that revolutionized the production of oil and gas in America, providing the nation with a secure supply of oil and natural gas. Notice American refineries and utilities benefitting from this domestic low-cost feedstock to produce gasoline and clean electricity. Cue the brilliant mind of Elon Musk, who notices this new source of cheap electricity and innovates electric-fueled cars now manufactured in America under the name "Tesla Motors". Next on deck are global petrochemical companies who also take notice of this energy innovation with many building new American plants that convert American energy into petrochemicals and fertilizers. American farmers then benefit from low-cost reliable sources of fertilizers that they use to harvest crops and increase farm production. And so a single innovation has compounded into the potential innovation of an entire economy. Notice GDP growth now driven from increased business investment, production, and exports while consumption slows and government spending falls."

What is lost in the paragraph above is that all this innovation works to bring down prices. Innovation in energy completion methods reduces the cost of producing oil and gas which reduces transportation, electricity, and heating costs. New local fertilizer plants reduce the cost of making food. Apple moving manufacturing operations to China reduces the cost of making I-Phones and I-Pads. So we highlight that this thriving niche economy is working to naturally reduce our cost-of living. Alternatively, global central banks have a 2% inflation target. Central banks see lower food, gasoline, electricity, I-Pod and real estate prices as a major risk. They will likely move to devalue their currency and cause prices to rise again.

Conclusion

Prices may continue declining in the short-term as innovation works to naturally reduce them. However, it is likely that central banks view this as a risk and respond by devaluing their currency, which translates into higher prices. Whether this occurs in one day, one month, one year, or one decade we do not know. This makes asset allocation extremely difficult. 1. Do we own cash when we feel the government will be devaluing its purchasing power in the near or distant future? 2. Do we own hard assets when innovation is occurring to naturally bring these prices down? Today our fund is invested 44.6% in hard assets, 41.9% in companies, and 13.5% in cash and fixed income. Deflation in the last three months has caught us off-guard as cash is the best investment for real returns in such a scenario. Our outlook on the future is clouded, we are considering increasing cash/fixed income allocation with a view that prices may naturally continue declining while also acknowledging that we are quick to have our hand on the door, worried that central banks may respond by devaluing currency purchasing power at anytime. Our objective is to have investors afford 2-10% more each year. If our cost-of-living rises 40% then our objective is to return 42-50%. If our cost-of-living falls 30% then our objective is a negative return of 22-28%. By not targeting more than 10% real returns then we never take excessive risk relative to our cost-of-living. So while it seems odd that we would ever target a negative return, we highlight that in all extreme scenarios investors are able to purchase 2-10% more goods and services. This enables them a higher standard of living and an earlier retirement date in any environment.

PATHFINDER PARTNERS' FUND

The Partners' fund has been active in the last few weeks, with general market malaise and increased volatility providing the opportunity to put our cash to work. We have covered our shorts, decreased our cash position, and initiated three new core positions which we plan to highlight once we have finished accumulating. With respect to specific fund holdings, Spectra7 Microsystems Inc (TSXv:SEV) announced the order for its VR7050 and VR7100 Virtual Reality (VR) chips to be deployed in over 500,000 devices. Spectra7's VR chips can reduce the number of cables required in a system from 4 to one, increase video throughput by up to 100%, and reduce the cable conductor crosssectional area and weight by up to 90%. We believe these chips will be a core enabling technology that allows for the mass consumer adoption of VR Systems. With the announcement that they had arranged for a senior secured loan, we believe Spectra7 is positioned with enough cash to successfully execute on their business plan.

CORE PORTFOLIO TRADES

Labrador Iron Ore Income Fund (TSX:LIF) Remove @22.32

Early last week BHP Billiton, Vale and Rio Tinto all announced that they would significantly increase iron ore production in an attempt to drive the price down in order to ultimately remove higher cost material from the global supply chain. While we remain comfortable with the LIF's business model, the dividend would not be sustainable in a commodity price war. We had already sold our position in the Core: Equity portfolio in order to purchase Enbridge Inc. (TSX:ENB) and were quick to sell the position in Core: High Income once the news broke

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Sources: Bloomberg, Financial Times, Pathfinder Asset Management Limited