COVENANT
CAPITAL MANAGEMENT INC.

INVESTORS' JOURNAL

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A New Year Reminder

For many, the close of 2012 was marked by the shocking violence of yet another mass killing in the U.S. This time the tragedy felt even harsher as so many of the victims were children. Since then, and I am sure for some time to come, the media, politicians and others will analyze and reanalyze the incident. What were the contributing factors? Who was really at fault? Would fewer guns solve the problem? Would more guns solve the problem? There may be something more fruitful to be observed. Surely, at few other times are we more keenly aware of the extent to which sin operates in and intrudes upon our daily lives. At few other times are we drawn so convincingly to our need for the gospel. The world will continue to bombard us with bad news; suffering, pain and loss are guaranteed attributes of our human condition. How stark a contrast is the undeserved, eternal rest and peace provided by our Savior. It can be a stretch to place the murder of children in the context of His overarching care for our souls. But if we can, surely we can also do the same with the emotional, financial, relational, business and family difficulties that tempt us to sometimes question whether He is truly for us. For some of us, 2013 will bring unforeseen difficulties, perhaps even suffering. Perhaps even loss. How we respond and are affected will be impacted by the length of time since we took a long, careful look at the cross.

Market Observations

United States

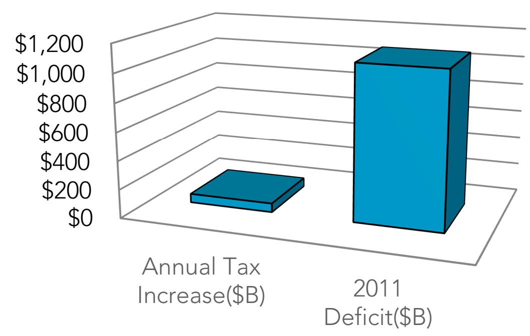
The end of 2012 saw the US S&P 500 normalized index (the blue line), finally recoup its losses since hitting a low in March 2009. It is the first major index to do so, with Canada's TSX (green) and MSCI's Europe Australasia and Far East index (purple) still having some ground to make up.

Source: Factset

Stock markets again dumbfounded many doomsayers that had predicted a bear market based on fundamentals and valuations. Their pessimism may have been misplaced, overlooking the benefits to the stock market of the US Federal Reserve's unrelenting printing of money.

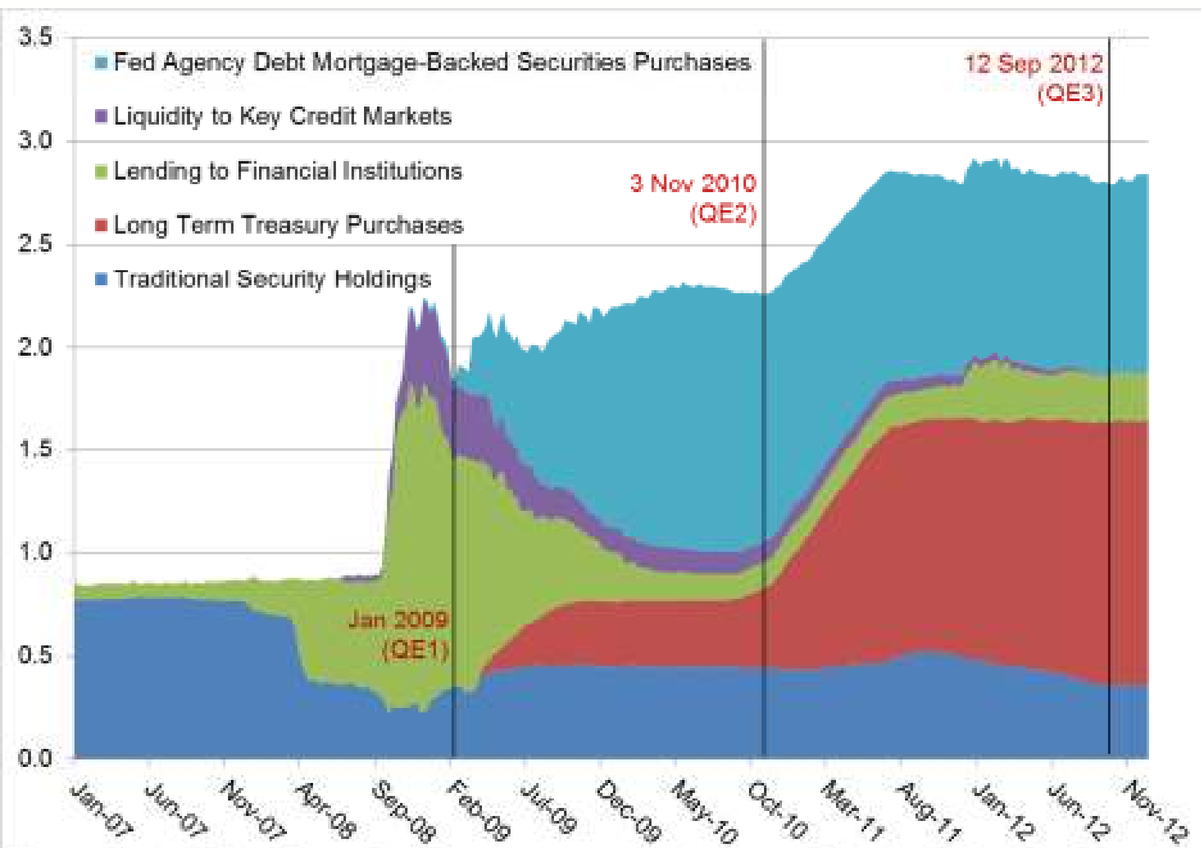
Currently, US government fiscal talks dominate the mass media. In reality, the US budget deficit has been back-stopped by the Federal Reserve's printing of $3 trillion (perhaps $4 trillion by end of this year) or roughly $1 trillion a year to make up the gap between spending and tax revenue. The latest quantitative easing places no time limit on the printing of $85 billion per month until US unemployment hits 6.5%. The Fed has also promised to keep short-term interest rates low until mid-2015. This is a new kind of expectation management intended to boost consumer and corporate confidence.

US Tax Revenue versus Deficit ($Billion)



	Annual Tax Increase($B)	2011 Deficit($B)
Amount	$62	$1,089

While a rise in the US equity market was a secondary effect of the Fed's policy, economic growth is still operating below its full potential.



Source: Cleveland Federal Reserve, TransEconomics **Fuente:** Reserva Federal de Cleveland, TransEconomics

Elsewhere in the World

The European Central Bank (ECB) has been just as determined in its back door support for European markets. Its balance sheet increased by as much as the Fed's at more than Euro $3 trillion during the same period. Unfortunately, the economy has slipped back into recession for the second time in four years and 2013 performance is expected to be only slightly better than stagnation. In Japan, newly-elected Prime Minister Mr. Shinzo Abe is also calling for similarly aggressive monetary stimulus in order to avoid deflation.

Unfortunately, history is not on the side of this kind of stimulus. Japan had a very disappointing experience with zero interest rates and quantitative easing programs in the 1990's. Their government tried to rescue insolvent companies and banks after their real estate bubble burst, but this simply delayed the inevitable restructuring until later in the decade.

The massive money printing and liquidity injections by the FED, BOJ, and ECB have yet to produce real economic revival. More money printing is expected going forward where the end-game may be the creation of a new bubble through misallocation of assets. On a brighter note, China is expected to maintain its average growth of 8% this year.

Portfolio Updates

In the face of persistent uncertainty in the markets, our balanced investment strategy has withstood the stress test of the last 5 years. Our Core 50 portfolio (50% equity) has outperformed the Canadian TSX Index (100% equity) providing positive returns over 1, 2, 3 and 5-years. In essence, we took less risk but achieved a higher return, giving our clients significant outperformance on a risk-adjusted basis.

We actively resist responding to every ripple in the financial markets. Prudence, rather than haste, is more likely to yield acceptable long-term returns. However, constant monitoring and the identification of trends allow us to make well-considered, strategic changes to our models. We have recently seen the need for two such adjustments:

Replacing Our High Yield Bonds

With interest rates historically low, finding yield without taking unnecessary risk is more challenging than ever. Within the high yield bond market specifically, we are seeing this trend become more prevalent and the accumulation of risk for the meager returns projected in 2013 is concerning. In November 2012 we sold the AGF Total Return Bond Fund (previously called AGF Global High Yield Bond Fund) in our portfolios and invested the proceeds in the PIMCO Monthly Income Fund.

While relatively new to Canada, PIMCO is a global company with over 2000 employees and $1.82 trillion in assets under management. We are excited to partner with a firm with such an excellent track record and whose investment philosophy closely mirrors our own.

True diversification, a bottom up and top town approach (ensuring exposure in the right sectors, through investments that are not overvalued), and rigorous risk management are all values we hold in common and which we believe will lead to a stable portfolio with strong long term returns.

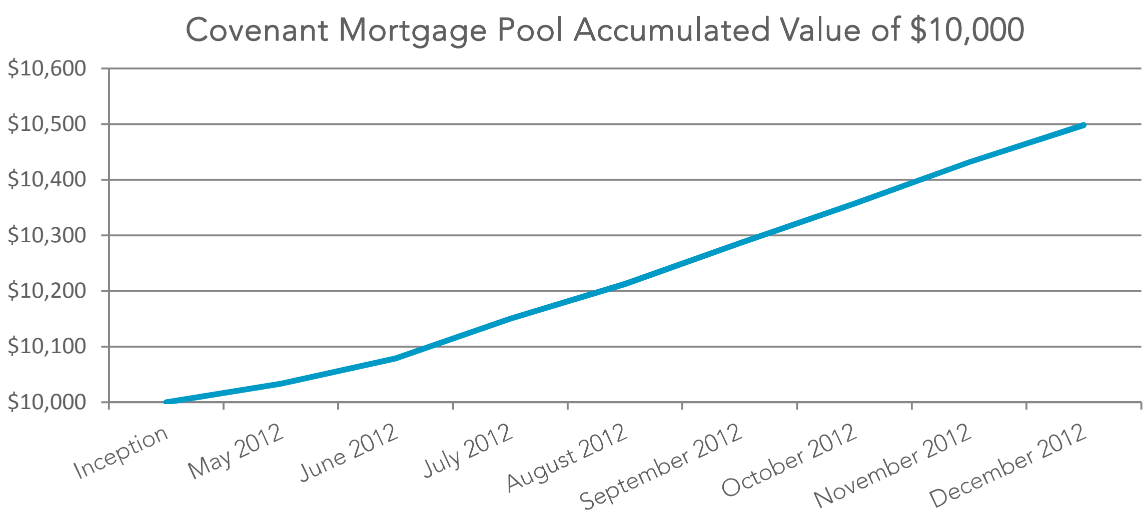
While the PIMCO fund retains some exposure to the high yield bond market, we believe its strategic, multi-sector approach better addresses conditions in today's fixed income marketplace. Additionally, adding income into the portfolio is a key ingredient to risk reduction and the PIMCO Monthly Income Fund focuses on maintaining a competitive income yield while still preserving capital. The Fund hedges currency for a very minimal cost, allowing it to participate in global bond markets without adding the risk of currency exposure.

Increased Allocation To The Covenant Mortgage Pool

Our first 'home grown' investment was launched in April 2012 and so far, it has met all our expectations. With low correlation to most other fixed income assets, the Covenant Mortgage Pool has strengthened diversification in our models and is on track to achieve its targeted 8% return in its first year of operation.

RETURNS: (as of December 31, 2012)

	APR	MAY	JUN	JUL	AUG	SEPT	OCT	NOV	DEC	3 MONTH	6 MONTH	YTD
2012	Incept.	0.33%	0.45%	0.71%	0.63%	0.73%	0.71%	0.75%	0.67%	2.14%	4.24%	5.03%



We initially felt that a 10% allocation was appropriate across all our standard models. However, persistent low interest rates and attendant risks in the bond markets have led us to reevaluate our approach. We are increasing the allocation to 12% for Core 60 models, rising to 20% for Core 20 models. Core 70 & 80 models remain unchanged at 10%. The strategy here is that the more a portfolio relies upon its fixed income for returns, the larger should be the exposure to the yield from the Mortgage Pool. A strategic change of this nature requires an update to our clients' Investment Policy Statements; these will be provided in the near future.

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Other Changes

In Core Equity, we took profit in 2012 on Diagio and US Bancorp while adding JP Morgan at a very attractive price. In Special Equity, we continue to hold silver with a reasonable expectation for it to outperform this year.

Covenant's CORE 50 Portfolio Update

December 31, 2012

DATE	S&P TSX	S&P500	MSCI EAFE	CORE 50
3 Year	1.91%	6.54%	-1.36%	6.3%
2 Year	-3.83%	6.37%	-1.83%	5.1%
1 Year	4.00%	10.56%	10.25%	6.0%
Year to Date	4.00%	10.56%	10.25%	6.0%

Notes:

1. *The number represented by the "Core" model denotes that model's maximum exposure to equities (e.g. Core 50 Model has up to 50% equity exposure).*
2. *Returns for the Core50 Models are composites of actual client portfolios. Returns for individual portfolios will have some variance from the composites due to the timing of cash flows and different acquisition dates of component securities.*
3. *Returns for the Core Models are after all management fees and transaction costs.*
4. *Returns for the stock indices assume no transaction or management costs; in practice, accessing these markets would incur costs of some type.*
5. *Our standard management fee is 1% per year, with discounts applied to portfolios over $3 million. Covenant's fees may be tax deductible, further enhancing effective returns.*

In October we celebrated as Christian and his wife Laura welcomed the safe delivery of their first child. Matthew is a healthy, happy boy blessing his parents with much joy (and possibly the odd sleepless night!)

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In December Elyse took the opportunity to serve orphaned children in Uganda. She returned with many encouraging stories of God's kindness being extended by the ministry of the Watoto organization. While each of us has countless opportunities to minister within our own communities, something very special happens when someone answers the call, at some personal risk and cost, to care for 'the least of these'. It is significant that throughout scripture, God provides the orphaned child as a primary target for our compassion. Thank you Elyse - we are grateful for your example.

Footnote

Thanks for bearing with us through this longer-than-usual edition of Investors' Journal. Our normal policy is to keep the newsletter to around four pages, with technical jargon at a minimum. However, it seemed that in light of the current-global financial environment, a more thorough examination would serve our readers – on this occasion.

Thanks again for your patience!