

# Management's Discussion and Analysis

In accordance with securities regulatory requirements, the discussion and analysis which follows for Guardian Capital Group Limited ("Guardian") pertains to the year ended December 31, 2016, with comparatives for the year ended December 31, 2015. Readers are encouraged to refer to the discussions and analyses contained in the 2015 Annual Report and the First, Second and Third Quarter 2016 Reports. This discussion and analysis has been prepared as of February 22, 2017.

Additional information relating to Guardian and its business, including Guardian's Annual Information Form, is available on "SEDAR" at [www.sedar.com](http://www.sedar.com).

## CAUTION CONCERNING FORWARD-LOOKING STATEMENTS

Guardian may, from time to time, make "forward-looking statements" in annual and quarterly reports, and in other documents prepared for shareholders or filed with securities regulators. These statements, characterized by such words as "goal", "outlook", "intends", "expects", "plan", "prospects", "are confident", "believe" and "anticipate", are intended to reflect Guardian's objectives, plans, expectations, estimates, beliefs and intentions.

By their nature, forward-looking statements involve risks and uncertainties. There is a risk that these forward-looking statements will not be achieved. Undue reliance should not be placed on these statements, as a number of factors could cause actual results to differ from Guardian's objectives, plans, expectations and estimates reflected in the forward-looking statements.

## OVERVIEW OF GUARDIAN'S BUSINESS

Guardian is a diversified financial services company, which serves the wealth management needs of a range of clients through its various business segments. The areas in which Guardian operates are: institutional and private wealth investment management; financial advisory, which includes an insurance managing general agency ("MGA"), a mutual fund dealer, and a securities dealer (together, the "Dealers"); and corporate activities and investments. Guardian is headquartered in Canada and operates in Canada, the United Kingdom ("UK"), the United States ("US") and the Caribbean. During the second quarter of 2016, Guardian formed a subsidiary, Guardian Capital LLC ("Guardian LLC"), in the US to operate as a marketing agent for the investment management business. As at December 31, 2016, Guardian had \$27.3 billion of assets under management ("AUM") and \$16.5 billion of assets under administration ("AUA"). In addition, Guardian has a diversified portfolio of securities which, together with its investment in Bank of Montreal ("BMO") shares, had a fair value of approximately \$620 million at the end of the year.

## 2016 HIGHLIGHTS

Guardian spent much of 2016 investing in the business, to build the necessary infrastructure for future growth. In line with its strategic plan, Guardian continued its efforts to grow its non-domestic AUM, to invest in operational and technological improvements and to more actively manage its securities portfolio.

In efforts to grow its non-domestic AUM, Guardian completed its initial buildout of the Fundamental Global and Emerging Markets Equities investment management teams in the UK, to complement its more mature Systematic Global Equities team in Canada, and increased its marketing and sales efforts of these strategies in key targeted markets, including the US where a new team of marketing professionals were hired. Guardian also reallocated capital to increase its seeding of investment vehicles managed by these teams, to provide them with better scale to attract third party investors. This reallocation occurred as part of the active management of Guardian's securities portfolio, with the sale in 2016 of 531,120 BMO shares, for proceeds of \$43.3 million, resulting in a reduction in the concentration of the portfolio in Canadian equities, including the BMO shares. As at December 31, 2016, the investment in BMO shares represented 62% of the portfolio, and all Canadian equities represented 68%, reduced from 66% and 72%, respectively, in 2015.

Guardian also made investments in additional expenditures and resources, on technology and other operational improvements, to prepare it for its next phase of growth. These investments, together with those in support of the non-domestic strategies referred to above, will continue to have a dampening effect on our earnings in the near term, but are expected to lead to improved earnings in the future.

Despite investing in its business in 2016, as stated above, Guardian delivered another historic high in its operating earnings. The 2016 operating earnings were \$44.7 million, a 4% increase from \$43.0 million in 2015. Included in the operating earnings were \$4.8 million in operating losses to support the buildout of the UK and the real estate investment management capabilities and the enhancement of the marketing and distribution capabilities in key markets. In 2015, the operating losses related to the buildout of the UK and the real estate team amounted to \$3.5 million.

In addition to operating earnings, Guardian reached new highs in net revenue, value of Securities, Shareholders' Equity, Adjusted Cash Flow from Operations, EBITDA, AUM and AUA.

With the improved earnings and cash flow, Guardian returned to shareholders \$33.6 million in the form of repurchases of shares and dividend payments during the year, another historic high. In 2015, \$23.0 million was returned to shareholders.

## USE OF NON-IFRS MEASURES

Guardian's management uses certain measures to evaluate and assess the performance of its business. Two of the measures that Guardian uses, EBITDA and adjusted cash flow from operations, are not defined within International Financial Reporting Standards ("IFRS"). Non-IFRS measures do not have standardized meanings prescribed by IFRS, and are therefore unlikely to be strictly comparable to similar measures presented by other companies.

However, Guardian's management believes that most shareholders, creditors, other stakeholders and investment analysts prefer to include the use of these measures in analyzing Guardian's results.

### EBITDA

Guardian defines EBITDA as net earnings before interest, income tax, amortization, stock-based compensation, and any net gains or losses, less amounts attributable to non-controlling interests. Guardian believes this is an important measure, as it allows management to assess the operating profitability of our business and to compare it with other investment management companies, without the distortion caused by the impact of non-core business items, different financing methods, levels of income taxes, the amounts of net earnings available to non-controlling interests and the level of capital expenditures. The most comparable IFRS measure is "Net earnings", which is disclosed in Guardian's Consolidated Statements of Operations.

The following is a reconciliation of the IFRS measure to this non-IFRS measure:

For the years ended December 31 (\$ in thousands)	2016	2015
Net earnings, as reported	\$ 70,575	\$ 44,977
Add (deduct):		
Income tax expense	12,709	9,061
Net gains	(38,617)	(11,040)
Stock-based compensation	1,731	1,506
Interest expense	837	868
Amortization	4,185	4,063
Non-controlling interests	(1,871)	(1,609)
EBITDA	\$ 49,549	\$ 47,826

### Adjusted Cash Flow From Operations

Adjusted cash flow from operations is used by management to indicate the amount of cash either provided by or used in Guardian's operating activities available to shareholders, without the distortions caused by fluctuations in its working capital. Many companies similar to Guardian use a similar measure in this manner. The most comparable IFRS measure is "Net cash from operating activities", which is disclosed in Guardian's Consolidated Statements of Cash Flow.

The following is a reconciliation of the IFRS measure to this non-IFRS measure:

For the years ended December 31 (\$ in thousands)	2016	2015
Net cash from operating activities, as reported	\$ 42,515	\$ 33,777
Add (deduct):		
Net change in non-cash working capital items	(2,454)	5,679
Non-controlling interests	(1,402)	(1,109)
Adjusted cash flow from operations	\$ 38,659	\$ 38,347

## CONSOLIDATED FINANCIAL RESULTS

The comparative financial results of Guardian on a consolidated basis are summarized in the following table:

For the years ended December 31 (\$ in thousands, except per share amounts)	2016	2015	% change
Net revenue	\$ 142,686	\$ 132,911	7%
Expenses	98,019	89,913	9%
Operating earnings	44,667	42,998	4%
Net gains	38,617	11,040	250%
Earnings before income taxes	83,284	54,038	54%
Income tax expense	12,709	9,061	40%
Net earnings	\$ 70,575	\$ 44,977	57%
Available to shareholders			
Net earnings	\$ 69,475	\$ 44,105	58%
EBITDA	49,549	47,826	4%
Adjusted cash flow from operations	38,659	38,347	1%
Available to shareholders, per share, diluted			
Net earnings	\$ 2.32	\$ 1.44	61%
EBITDA	1.66	1.56	6%
Adjusted cash flow from operations	1.30	1.25	4%
As at December 31 (\$ in millions, except per share amounts)	2016	2015	% change
Assets under management	\$ 27,280	\$ 24,278	12%
Assets under administration	16,489	14,943	10%
Shareholders' equity	580	504	15%
Securities	620	540	15%
Per share, diluted			
Shareholders' equity	\$ 19.62	\$ 16.55	19%
Securities	20.97	17.72	18%
For the years ended December 31 (\$ in millions)	2016	2015	% change
Annual premiums on insurance policies sold	\$ 90	\$ 56	61%

Guardian's operating earnings in 2016 were \$44.7 million, a historic high, compared to \$43.0 million in 2015, a 4% increase. The growth in operating earnings was achieved while continuing to invest in the business, as indicated under "2016 Highlights", above. These investments will continue to have a dampening effect on operating earnings in the near term, but are expected to lead to improved operating earnings in the future.

The operating earnings from the Investment Management segment were \$20.2 million in 2016, a 9% increase from \$18.4 million in 2015. The biggest contributors to this increase were the Private Wealth and International Private Banking businesses, benefiting from a very large net inflow of Private Wealth client assets and an increased level of banking transaction fee income in 2016. We continued to absorb the operating losses in the UK and real estate operations and added new costs associated with building a distribution team in the US. The operating losses associated with these operations in 2016 were \$4.8 million, compared to \$3.5 million associated with the UK and the real estate investment management business.

In the Financial Advisory segment, the operating earnings increased to \$11.0 million compared to \$10.1 million in 2015, an 8% increase. The growth was largely driven by the successes in the MGA business, while the Dealers focused on operational improvements of their business.

The operating earnings in the Corporate Activities and Investments segment decreased to \$13.5 million in 2016, from \$14.5 million in 2015. The decrease in operating earnings in this segment resulted largely from the strategic decision to reallocate a portion of the investment in BMO shares into proprietary investment funds, which generally provide lower operating earnings compared to the dividends paid on the BMO shares.

The net gains in 2016 were \$38.6 million, an increase of \$27.6 million from 2015. The largest contributor to the increase was the increased gains recognized on the disposal of 531,120 BMO shares in 2016, compared to 204,000 shares in 2015.

Higher income tax expense in 2016 was the result of higher operating earnings and higher net gains realized during the year, compared to 2015.

Net earnings available to shareholders for 2016 were \$69.5 million, compared to \$44.1 million in 2015, a 58% increase. The increase was the result of improved operating earnings and the significant increase in net gains in 2016.

EBITDA for 2016 was \$49.5 million, compared to \$47.8 million in 2015, a 4% increase. Adjusted cash flow from operations for the year amounted to \$38.7 million, compared to \$38.3 million in 2015, a 1% increase. The increases in both of these measures were caused by the improvements in operating results, as described above.

The per share amounts in net earnings, EBITDA, and adjusted cash flow from operations, increased as a result of the continued improvements in operations, and the benefits of the repurchase of 1.2 million shares in 2016.

## REVENUES AND EXPENSES

### *Investment Management Revenues*

The largest source of revenue at Guardian are management fees received from clients, which vary as a result of changes in the amounts of client assets managed, and variations in the rates of management fees charged.

The following is a summary of the assets under management:

Years ended December 31 (\$ in millions)	2016	2015
Assets under management, beginning of year	\$ 24,278	\$ 24,968
Net additions (reductions) from clients during year	282	(775)
Market appreciation	2,720	85
Assets under management, end of year	\$ 27,280	\$ 24,278
Composed of:		
Institutional	\$ 24,380	\$ 21,994
Private wealth and international private banking	2,900	2,284
Total	\$ 27,280	\$ 24,278
Institutional AUM is composed of:		
Canadian equities	\$ 13,294	\$ 11,715
Global equities	3,306	3,389
Fixed Income	7,780	6,890
Total institutional AUM	\$ 24,380	\$ 21,994

Guardian's total AUM were \$27.3 billion at December 31, 2016, compared to \$24.3 billion at the end of the prior year, a 12% increase. The strong positive performance in the Canadian equity market provided a tailwind to Guardian's AUM, composed largely of Canadian equities. This positive effect was partially offset by the retail investor segment, which continued to reduce allocations to Canadian equities, and by the rebalancing of portfolios out of Canadian equities by institutional investors, after strong returns. Although the allocations were reduced, we retained substantially all our institutional clients, witnessed a strong net inflow of assets into the Private Wealth business and experienced some moderate successes in gathering third-party assets in the Undertakings for Collective Investments in Transferable Securities ("UCITS"), managed by our UK subsidiary.

Management fees, net of referral fees paid, for the year 2016 were \$68.2 million, 5% higher than the \$65.3 million for 2015. Institutional management fees increased 3% to \$52.4 million in 2016 from \$51.5 million in 2015, as a result of higher average AUM in 2016. Private Wealth and International Private Banking management fees, net of referral fees paid, increased 10% during the year to \$15.8 million from \$13.8 million in 2015, reflecting the large increase in AUM in this business.

### *Financial Advisory Commission Revenues*

Net commission revenue earned from the Financial Advisory business is generated from the sale of life insurance products, mutual funds and other securities, as well as from continuing fees related to AUA and in force life insurance policies, net of commissions paid to advisors.

Total AUA at Guardian at the end of 2016 amounted to \$16.5 billion, 10% higher than the \$14.9 billion at the end of 2015. The increase in AUA was due to successful recruitment efforts, net new sales, and the market performance during the year.

The Annual Premiums on Life Insurance Policies Sold ("Annual Premiums Sold") in 2016 by the MGA subsidiary were \$90.4 million, compared to \$56.0 million in 2015, a 61% increase. The Annual Premiums Sold generate sales commissions in the year they are sold, and add continuing annual service commission revenue in subsequent years. This continuing stream of service fee revenue was \$9.8 million in 2016 and \$8.3 million in 2015.

Net commission revenue from the Financial Advisory business amounted to \$38.4 million in 2016, 13% higher than the \$33.9 million in 2015. The MGA net commission revenue increased to \$25.2 million from \$21.5 million in 2015. The increase was due largely to the increase in Annual Premiums Sold, as described above, and the increase in continuing annual service commission revenue, resulting from prior years' Annual Premiums Sold. Included in the increase is \$1.0 million in additional revenue earned from the First Prairie business acquired on June 1, 2015. The Dealers net commission revenue increased to \$13.2 million from \$12.4 million in 2015. The increase was largely the result of higher average AUA in the Dealers business in 2016.

#### *Administrative Services Income*

Administrative services income in 2016 was comprised of \$7.7 million of registered plan and other fees earned in the Financial Advisory area, \$3.5 million in fund administration revenue earned from Guardian's proprietary mutual funds and other fees earned in the domestic investment management area and \$3.4 million of trust, corporate administration and other fees earned mainly in the International Private Banking area, for a total of \$14.6 million, compared with \$12.7 million in 2015. The increase is largely as a result of the significant increase in banking transaction fees earned in the International Private Banking business.

#### *Dividend and Interest Income*

The following is a summary of Guardian's dividend and interest income:

For the years ended December 31 (\$ in thousands)	2016	2015
Dividend on Bank of Montreal shares	\$ 14,442	\$ 15,175
Other dividends	5,383	4,667
Dividend income	19,825	19,842
Interest income	1,706	1,257
Total dividend and interest income	\$ 21,531	\$ 21,099

Dividend and interest income increased by 2% in the year, largely due to the increased interest income earned in the International Private Banking business and to a lesser extent from fixed income investments held by the Corporate Activities and Investments segment. The total dividend income was substantially unchanged from the prior year. The reallocation of a portion of the securities portfolio from BMO shares to proprietary investments resulted in a reduction of dividend income from BMO shares, offset by an increase in other dividend income. As Guardian continues to strategically reallocate its securities portfolio to support the growth of its operating businesses, this source of income is expected to fluctuate.

#### *Expenses*

Guardian's operating expenses, excluding commissions, referral fees, amortization and interest, were \$93.1 million in 2016, compared with \$85.0 million in 2015, an increase of 10%. The increase in expenses is largely related to expenditures to support the strategic investments in the business. The increase in employee compensation and benefits expenses are due to the hiring of additional investment professionals in the UK, the new distribution and marketing capabilities in the US, the new head of the Private Wealth business and additional resources to support continued operational and technology improvements. The increase in other expenses is largely the result of increased marketing expenses, increased technology expenditures and other operational expenses to support the growth of the business. Included in the increased expenses for 2016 were \$0.4 million of additional expenses due to the full year inclusion of First Prairie's expenses.

#### **NET GAINS**

For the years ended December 31 (\$ in thousands)	2016	2015
Net gains in consolidated investment funds	\$ 13,080	\$ 2,823
Net gains on securities directly held	25,161	8,709
Net gains on securities	38,241	11,532
Net foreign exchange (losses)	(644)	(1,223)
Net gains on disposal of intangible assets	1,020	731
Impairment of intangible assets	–	(695)
Gain on other liability	–	695
Net gains	\$ 38,617	\$ 11,040

Net gains in 2016 increased compared to 2015, largely due to the increased gains recognized on the sale of 531,120 shares of BMO for proceeds of \$43.3 million in 2016, compared to 204,020 shares sold for proceeds of \$15.4 million in

2015. Guardian used the proceeds of disposition of BMO shares to invest in proprietary funds, which are consolidated into Guardian's results. The increased investment in these funds resulted in increased amount of net gains, which are recorded within these funds, being consolidated into Guardian's results.

## LIQUIDITY AND CAPITAL RESOURCES

The strength of Guardian's balance sheet has enabled Guardian to attract associates, provide clients with a high comfort level, maintain the appropriate levels of working capital in each of its areas of operation, make the necessary capital expenditures to develop and support its businesses and make appropriate use of borrowings, including financing the expansion of its businesses. The hallmark of Guardian's balance sheet is the significant securities portfolio as presented below.

As at December 31 (\$ in thousands, except per share amounts)	2016	2015
Securities at fair value:		
Short-term securities	\$ 12,567	\$ 2,058
Bonds	1,147	1,102
Fixed income mutual funds	9,449	8,139
Equity investment funds	27,599	47,949
Bank of Montreal common shares	386,240	353,790
Other equity securities	159,457	104,598
Real estate funds	23,759	22,284
<b>Total securities</b>	<b>\$ 620,218</b>	<b>\$ 539,920</b>
<b>Total securities per share, diluted</b>	<b>\$ 20.97</b>	<b>\$ 17.72</b>

Guardian's securities as at December 31, 2016 had a fair value of \$620 million, or \$20.97 per share, diluted, compared with \$540 million, or \$17.72 per share, diluted, as at December 31, 2015, as shown above. In addition, Guardian's shareholders' equity as at December 31, 2016 amounted to \$580 million, or \$19.62 per share, diluted, compared to \$504 million, or \$16.55 per share, diluted, as at December 31, 2015.

Guardian has available, under various borrowing arrangements, total credit of \$103 million. At December 31, 2016, the total bank borrowing amounted to \$62.7 million, compared with \$54.8 million at December 31, 2015.

Guardian generated adjusted cash flow from operations of \$38.7 million in 2016, an increase of \$0.4 million from \$38.3 million in 2015. At current levels of cash flow and anticipated dividend payout rates, Guardian generates sufficient cash flow to meet its obligations, make capital expenditures and repurchase its shares under Normal Course Issuer Bid.

In 2016, using its strong balance sheet, its borrowing capacity and its strong cash flow, Guardian returned \$33.6 million to the shareholders in the form of dividends and share repurchases, increased its investments into two key investment funds by approximately \$53.0 million and invested approximately \$3.4 million in recruitment of top producing advisors in the Financial Advisory businesses.

## CONTRACTUAL OBLIGATIONS

Guardian has contractual commitments for the payment of certain obligations over a period of time. A summary of those commitments, including a summary of the periods during which they are payable, is shown in the following table:

As at December 31, 2016 (\$ in thousands)	Total	Within one year	One to three years	Three to five years	After five years
Bank loans and borrowings	\$ 62,664	\$ 62,664	\$ –	\$ –	\$ –
Third party investor liabilities	99,452	99,452	–	–	–
Client deposits	77,364	77,364	–	–	–
Accounts payable and other liabilities	44,828	44,129	699	–	–
Payable to clients	60,672	60,672	–	–	–
Investment commitment – real estate fund	11,834	11,834	–	–	–
Operating lease obligations	15,658	2,069	3,484	3,709	6,396
<b>Total contractual obligations</b>	<b>\$ 372,472</b>	<b>\$ 358,184</b>	<b>\$ 4,183</b>	<b>\$ 3,709</b>	<b>\$ 6,396</b>

Guardian's contractual obligations are supported by its strong financial position, including its securities, referred to above under "Liquidity and Capital Resources". Client deposits, in the offshore banking subsidiary, are supported by interest-bearing deposits with banks. The third party investor liabilities are offset by securities backing third party investor liabilities. The Payable to clients, in Guardian's securities dealer subsidiary, which can fluctuate with client activities, is offset by the Receivable from clients and broker. Guardian has committed to invest \$35.0 million into a real estate limited

partnership which is managed by a subsidiary, of which \$23.2 million has been invested as at December 31, 2016. The balance is expected to be invested as appropriate real estate product becomes available to the limited partnership, at which time Guardian's management will decide on the appropriate strategy for funding this commitment.

## SELECTED ANNUAL INFORMATION

Years ended December 31 (\$ in thousands, except per share amounts)	2016	2015	2014
Net revenue	\$ 142,686	\$ 132,911	\$ 119,275
Net earnings available to shareholders	69,475	44,105	37,017
Per share			
Net earnings available to shareholders			
Basic	\$ 2.44	\$ 1.50	\$ 1.23
Diluted	2.32	1.44	1.19
Dividends paid	0.33	0.29	0.24
As at December 31			
Total assets	\$ 982,262	\$ 810,249	\$ 736,757

The increases in total assets over the past two years substantially reflect the changes in the value of the corporate holdings of securities, increases in interest-bearing deposits and receivables from clients and brokers.

## SUMMARY OF QUARTERLY RESULTS

The following table summarizes Guardian's financial results for the past eight quarters.

Quarters ended (\$ in thousands)	2016				2015			
	Dec 31	Sept 30	Jun 30	Mar 31	Dec 31	Sept 30	Jun 30	Mar 31
Net revenue	\$ 38,240	\$ 35,185	\$ 34,191	\$ 35,070	\$ 34,353	\$ 33,188	\$ 33,066	\$ 32,304
Operating earnings	12,371	10,646	10,300	11,350	10,256	10,876	11,390	10,476
Net gains (losses)	10,754	10,057	1,028	16,778	9,658	(2,407)	602	3,187
Net earnings	19,859	17,475	9,169	24,072	17,362	6,278	9,786	11,551
Net earnings available to shareholders	19,417	17,353	8,887	23,818	17,138	6,053	9,604	11,310
Shareholders' equity	580,177	545,339	513,939	497,656	504,255	470,533	473,944	477,901

Per Class A and Common share:

Net earnings available to shareholders									
Basic	\$ 0.69	\$ 0.61	\$ 0.31	\$ 0.83	\$ 0.59	\$ 0.21	\$ 0.33	\$ 0.38	
Diluted	0.65	0.58	0.30	0.79	0.56	0.20	0.31	0.37	
Shareholders' equity									
Basic	\$ 20.75	\$ 19.11	\$ 18.08	\$ 17.51	\$ 17.37	\$ 15.96	\$ 16.08	\$ 16.15	
Diluted	19.62	18.07	17.10	16.63	16.55	15.23	15.32	15.42	
Dividends paid	\$ 0.085	\$ 0.085	\$ 0.085	\$ 0.075	\$ 0.075	\$ 0.075	\$ 0.075	\$ 0.065	

Management fees earned in the Investment Management segment and trailer commissions earned on mutual funds and segregated funds in the Financial Advisory segment are highly correlated to the change in AUM and AUA. Guardian may also earn performance management fees on certain accounts, which are determined on an annual and a quarterly basis, and these may be significant. The seasonality which in the past existed in the Financial Advisory segment, with some concentration of commissions in the traditional "RSP season" in the first quarter of each year, has now largely dissipated. This change is due to the continuing move toward "trailer" commissions and away from "front-load" sales commissions, and the increasing significance of commissions from the life insurance MGA, which are less influenced by the "RSP season" and the financial market movements. Some seasonality in the commission revenues now occurs in the MGA business, where the last quarter of the year sees an increase in revenues from "volume bonuses" earned from the life insurance companies. These volume bonuses are increasing each year and are becoming more significant as the business continues to grow. We are also now starting to see a trend developing in the dividend income, with the second quarter and the fourth quarter of each year seeing increases in revenue, due largely to dividends from foreign equities which pay semi-annual dividends during those periods.

The steady increase in net revenue during the periods shown above have generally resulted from two influences. Firstly, reflecting the growth in average AUM, management fees in the investment management business have increased steadily throughout 2016 and 2015. Secondly, there has been significant growth in commissions earned in the financial advisory business as a result of the continued business growth, organically, through recruitment of advisors, and through acquisitions.

Since gains and losses are recorded on disposal of available for sale securities or other assets, on changes in the value of held for trading and held for sale securities, and on changes in the value of foreign currency balances held, and such amounts can vary from quarter to quarter, the amounts included in “Net gains” each quarter have fluctuated, as shown in the quarterly results above.

The quarterly fluctuations in shareholders’ equity shown above have been caused largely by the changes in the value of Guardian’s securities holdings, less the provision for deferred income taxes thereon.

## **RISK FACTORS**

Guardian applies many of the same risk management principles to its business as a whole, as it does to the management of risks on behalf of its clients. One of the principles is that risk can pose challenges, as well as provide opportunities, depending upon the effectiveness of the way in which it is managed. Readers are encouraged to refer to the notes to the Consolidated Financial Statements, contained in Guardian’s 2016 Annual Report, for additional information on financial risk management.

### *Market Risk*

Market fluctuations can have a significant effect on the value of both clients’ portfolios and our earnings, since management fees are generally based on market values. Additionally, market fluctuations can impact the amounts being invested by the clients of our financial advisory businesses, increasing or reducing our commission revenues. We manage the risk of market fluctuations by having a diversified client base with different investment needs, and by having a variety of products and services, which may be attractive in different market environments and which have different correlations to equity and other financial markets and to each other. Guardian’s securities are managed independently of clients’ assets, except for those of our assets that are invested in Guardian’s investment funds.

### *Portfolio Value and Concentration Risk*

Guardian’s securities are subject to price fluctuation risk. Guardian manages this risk through professional in-house investment management expertise, which takes a disciplined approach to investment management. All securities are held by well-known independent custodians chosen by Guardian. With the exception of the investment of \$386 (2015 – \$354) million in the Bank of Montreal shares, which represents 62% (December 31, 2015 – 66%) of Guardian’s securities, they are diversified, from both an asset class and a geographical perspective. At the end of 2016, the securities were made up of 68% (2015 – 72%) Canadian equities, consisting mainly of the Bank of Montreal shares, 28% (2015 – 26%) non-Canadian equities and 4% (2015 – 2%) fixed income securities.

### *Foreign Currency Risk*

Guardian’s investments in its foreign subsidiaries are subject to the risk of foreign currency exchange rate fluctuations. The effects of changes in foreign currency exchange rates on the values of these investments are not included in Net earnings, but are recorded as changes in the “foreign currency translation adjustment” in Guardian’s Statements of Comprehensive Income, and the cumulative effect is included in Accumulated Other Comprehensive Income in the Shareholders’ Equity section of the Consolidated Balance Sheets. In addition, the operating results of these subsidiaries can fluctuate with the change in the foreign currency exchange rates against the Canadian dollars. These foreign currency exposures are not actively managed, due to the long-term nature of these investments, but is closely monitored by management. From time to time, the foreign subsidiaries hold unhedged Canadian dollars, which can result in foreign exchange gains or losses being recorded by the subsidiaries. Upon translation of their results on consolidation, Guardian recognizes equal and offsetting gains or losses in “Other comprehensive income”. This is not considered to be a currency risk as there is no economic risk to Guardian.

### *Credit Risk*

Guardian’s credit risk is generally considered to be low. Because of the nature of Guardian’s business, its receivables are mainly from large institutions, which are considered to pose a relatively low credit risk, or from individuals, which are secured by marketable securities. Guardian periodically reviews the financial strength of all of its counterparties, and if the circumstances warrant it Guardian takes appropriate action to reduce its exposure to certain counterparties. The credit risk associated with Guardian’s investment in fixed-income mutual funds is managed by the monitoring of the activities of the portfolio manager who, through diversification and credit quality reviews of the funds’ investments, manage the funds’ credit risk. From time to time, advisors in the Financial Advisory segment may owe to the Dealers or the MGA, advances received or amounts resulting from reversal of commissions. The credit risk associated with these

amounts are mitigated by management's review of the advisors' ability to repay the advances or the potential commission reversals, particularly in the MGA business, before amounts are paid to the advisors.

#### *Interest Rate Risk*

Guardian manages interest rate risk in its international banking operations, through matching the interest rates and maturity dates of client deposit liabilities with the assets, interest-bearing deposits with banks. The interest rate risk associated with Guardian's investment in fixed-income mutual funds is managed by monitoring the activities of the portfolio manager, who manages this risk by positioning the portfolio for various interest rate environments.

#### *Liquidity Risk*

Guardian manages liquidity risk through the monitoring and managing of cash flows from operations by establishing sufficient borrowing facilities with major Canadian banks, which currently total \$103 million through three credit facilities, and the support of its significant security portfolio. The maturities of Guardian's contractual commitments are outlined under "Contractual Commitments" in this discussion and analysis. The combination of the cash flows from operations, borrowing facilities and the holding of securities provides sufficient resources to manage its liquidity risk.

#### *Regulatory Risk and Legal Risk*

Guardian and its subsidiaries operate in an environment subject to various laws and regulations. Given the nature of certain of Guardian's subsidiaries, they may, from time to time, be subject to changes in regulations, claims or complaints from investment clients and sanctions from governing bodies. These risks are mitigated by maintaining relevant in-house competence in laws and regulations, compliance and product review oversight, adequate insurance coverage and, where appropriate, utilizing assistance from external advisors.

#### *Performance Risk*

Product performance presents another risk. It is a relative, as well as an absolute measure, because the risk is that we will not perform as well as the market, our peers, or in line with our clients' expectations. We manage this risk by having a disciplined approach to investment management, and by ensuring that our compliance capabilities are strong. With respect to clients' expectations, we also ensure that we are fully aware of all of those expectations, and that we properly communicate with our clients to develop, report on and comply with client mandates on a continuous basis.

#### *Financial Advisory Risk*

Because of the number of advisors who publicly represent each of the Worldsource operating entities, there are risks associated in their dealings with their clients. These risks are mitigated by the strong compliance and product review capabilities of the Worldsource organization, significant management oversight and insurance coverage carried by both Worldsource and the advisors.

#### *Competition Risk*

Guardian operates in a highly competitive environment, with competition based on a variety of factors including investment performance, the type and quality of products offered, business reputation and financial strength. Loss of client assets to competition will result in losses of revenue and earnings to Guardian. Guardian attempts to mitigate this risk by developing and maintaining a competitive product line and competitive relative performance of its products, through the recruitment and retention of high quality investment professionals and a high quality management team. Our ability to compete is also enhanced by our large capital base, which provides Guardian with the financial strength to invest in the development or acquisition of businesses. It also provides existing and future clients with comfort which allows Guardian to better compete in winning and retaining these clients.

#### *Information Technology and Cybersecurity Risk*

Guardian uses information technology and the internet to streamline business operations and to improve client and advisor experience. However, with the use of information technology, including the use of mobile devices, and the use of internet, such as emails and other online capabilities, Guardian is exposed to information security and other technology disruptions risks that could potentially have an adverse impact on its business. Guardian actively monitors this risk and continues to develop controls to protect against such threats that are becoming more sophisticated and pervasive.

### **CRITICAL ACCOUNTING ESTIMATES**

The preparation of consolidated financial statements in conformity with IFRS requires management to make estimates and assumptions which affect the reported amounts of assets, liabilities, contingencies, revenues and expenses. These estimates and assumptions are listed in note 2 (c) to Guardian's 2016 Consolidated Financial Statements. The most significant accounting estimates are related to the impairment assessment of goodwill and the determination of fair value of securities classified as level 3 within the fair value hierarchy.

The impairment assessment of goodwill includes a comparison of the carrying value and the recoverable amount of each business unit to verify that the recoverable amount of the business unit is greater than its carrying value. In 2016 and 2015, the recoverable amounts were estimated using the fair value less cost to sell method for each of the business units. Guardian used valuation approaches to determine fair value based on a multiple of AUM, AUA, annual service fee revenues and first year's commissions. These multiples are developed by management based on recent transactions and research reports by independent research analysts. These valuation approaches are most sensitive to the levels of AUM, AUA and annual service fees.

A financial instrument is classified as level 3 when the fair value of the instrument is determined using valuation techniques based on inputs which are not observable in the market. The fair values of securities classified as level 3 in note 3(b) to Guardian's 2016 Consolidated Financial Statements were based on a valuation approach using a multiple of AUM and further corroborated by a multiple of EBITDA observed in market transactions. The multiple was developed based on prior tender offers and recent research reports by independent research analysts for similar types of business. This valuation approach is most sensitive to the level of AUM and the EBITDA generated by these entities.

#### **FUTURE CHANGES IN ACCOUNTING POLICIES**

A number of new standards, and amendments to existing standards, have been issued by the International Accounting Standards Board ("IASB"), which are effective for Guardian's consolidated financial statements in future periods. Readers are encouraged to refer to note 2 to the Consolidated Financial Statements contained in Guardian's 2016 Annual Report, for Guardian's initial assessment of the potential impact of these new standards. Guardian continues to evaluate the impact these new standards will have on its consolidated financial statements. The following is a description of these new standards and amendments.

##### *Financial Instruments*

On July 24, 2014, IASB issued its fourth and final version of IFRS 9 Financial Instruments ("IFRS 9"), which is to replace IAS 39 Financial Instruments: Recognition and Measurement with revised guidance on classification and measurement of financial instruments. IFRS 9 is effective for annual periods beginning on or after January 1, 2018.

##### *Revenue*

On May 28, 2014, the IASB issued IFRS 15 Revenue from Contracts with Customers ("IFRS 15"), which establishes a new framework for the recognition of revenue from contracts with customers and replaces several other standards and interpretations. The core principle of IFRS 15 is that an entity recognizes revenue upon the transfer of services to customers that reflects the payments to which it expects to be entitled. IFRS 15 is effective for annual periods beginning on or after January 1, 2018.

##### *Leases*

On January 13, 2016, the IASB issued IFRS 16 Leases ("IFRS 16"), which is to replace IAS 17 Leases. The standard provides a single lessee accounting model, requiring lessees to recognize assets and liabilities for all leases unless the term is 12 months or less or the underlying asset has a low value. IFRS 16 is effective for annual periods beginning on or after January 1, 2019.

#### **INTERNAL CONTROL OVER FINANCIAL REPORTING AND DISCLOSURE CONTROL**

Management is responsible for establishing and maintaining adequate internal controls over financial reporting, to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with IFRS. There have been no changes in Guardian's internal control over financial reporting during the quarter ended December 31, 2016 that have materially affected, or are reasonably likely to materially affect, Guardian's internal control over financial reporting.

Management of Guardian has evaluated the effectiveness of its disclosure controls and procedures and internal controls over financial reporting (as defined under National Instrument 52-109) as of December 31, 2016, under the supervision of the Chief Executive Officer and the Chief Financial Officer. Based on that evaluation, the Chief Executive Officer and the Chief Financial Officer have concluded that the design and operation of those disclosure controls and procedures and internal controls over financial reporting were effective.

#### **OUTLOOK**

2016 was an eventful year that began in tumultuous fashion, with stock markets posting one of their worst starts to a year, due to fears about lack of growth in China. As the year progressed, global growth improved, resulting in improved equity market returns. In November, there was a positive response to Donald Trump's Presidential election victory, and some markets closed the year at all-time highs, such as the S&P 500, which posted a return of 12.0%, and the S&P/TSX, with a return of 21.1% in 2016. Globally, most markets in the developed world and the emerging markets

underperformed Canada and the U.S. Relative to the S&P 500, Japan and two of the three largest European markets, France and Germany, underperformed. Somewhat surprisingly, the U.K. (+19.2%) posted a solid gain, despite the potential for economic disruption related to Brexit.

In prior years, our bullish expectations were based on our belief that stocks were inexpensive relative to interest rates, and would benefit from P/E multiple expansion, as the memory of the financial crisis faded into the background and investors recognized that the U.S. economy was healing. From this point forward, the dynamics behind our bullishness are changing. Our bullishness for 2017 rests on two factors: first, the U.S. economy is accelerating sufficiently, even before a Trump tax cut or infrastructure spending. As such, we expect earnings to accelerate after a sluggish few years. This will benefit Canadian companies selling into, operating in, or benefiting from U.S. dollar-denominated commodity prices, even if the Canadian economy remains tepid as we anticipate. Second, we believe that low- and medium-priced stocks can still benefit from a P/E multiple expansion, either as headwinds to growth in earnings recede or as earnings growth accelerates. Globally, despite some long-term structural challenges arising from overcapacity and deteriorating demographics, we expect China and Asia, as a whole, will continue to grow, albeit at a rate slower than that to which we have become accustomed. With respect to Europe, the Brexit vote, and potential uncertainty from elections in the Netherlands, Italy and France, likely create headwinds for growth and inflation in the EU. The region has recently experienced a slight improvement in growth and an uptick in inflation. Sustained monetary stimulus by the ECB should lend support to keep the recovery going forward.

Guardian is highly levered to equity markets, in particular Canadian equities, across its main business segments as well as its corporate investment portfolio. Guardian's AUM increased to \$27.3 billion at the end of 2016, which is approximately \$3.0 billion more than at the end of the prior year. The increase in AUM was due largely to the positive market performance of the Canadian equity market. This is in stark contrast to 2015, when Canadian markets, affected by oil and commodity price declines, were among the few negative performers in the developed world. In 2017, it is likely that retail intermediary flows from the broker dealer wrap programs, and our retail mutual fund and exchange traded fund partners, will continue to provide us with net inflow of assets from their clients. However, we have seen in the past, and are seeing some signs now, that institutional, and to a lesser extent, retail clients have a tendency to reduce their exposure to Canadian equities, especially after a period of strong outperformance in Canadian markets.

For the last few years, Guardian has been building highly-skilled portfolio management teams in the UK, who use a fundamental approach to investing in global and emerging market equities. The AUM of these teams is still relatively small, but we believe we have proven our competence in managing these strategies, and that the products we offer are in demand. During 2017, we expect to see increasing sales in our fundamental offering, particularly in the Global product. We also expect to see some sales momentum from third party investment programs, as well as some institutional traction initiated by our US-based sales team. These US sales will initially benefit mainly our Global Dividend strategy, which is managed by our systematic team in Toronto. While we do expect increasing AUM from these channels, we still expect to generate operating losses from these initiatives for the next few years.

Guardian's management will continue to use its strong balance sheet to assist in our growth plans, by seeding new strategies to gain a track record of performance and test our theories on optimizing our investment management processes. We have found that substantial investments in newly-offered products can help us to gain clients in the early stages of our product development. Two recent examples of this are in our Real Estate and our Global Fundamental Equity strategies, where substantial commitments of our own capital accelerated attracting third party investors. Investing in our own products also serves the purpose of slowly and methodically diversifying from our core holding of shares in the Bank of Montreal, as well as reducing our large exposure to Canadian equities in general.

Another benefit of our balance sheet is to enable us to consider mergers and acquisition activity. While the lion's share of our recent acquisitions have been focused on growing our life insurance MGA business, we continue to explore and evaluate opportunities in a range of investments related financial service businesses.

Guardian's Financial Advisory business, through its subsidiary Worldsource Wealth Management ("WWM"), has continued on its growth path in 2016. Our patient building of these businesses has resulted in improved operating earnings from continued strong commission growth from new life insurance sales in the MGA business, and multi-year efforts to improve revenue growth and expense management in the Dealers business. 2016 marked the introduction of CRM II, which is a mandate by regulators to improve reporting of performance and disclosure of the fees and expenses involved in investing in mutual funds. Many people in the industry are worried that these disclosures will lead to disruptions in the advisors' businesses and downward pressures on their compensation as investors may become disenchanted with their advisors. While it is too early to be certain of the impact, Guardian expects that any adverse effects will also result in new opportunities. Guardian is already a reasonably low cost provider of mutual fund solutions to our advisors, and it is possible our strategies stand to benefit from the new disclosures. In the MGA industry, there are rumblings of new advisor supervision duties being imposed on the MGAs by regulators. If such requirements are imposed, we believe our MGA will have competitive advantages from having scale, and an existing comprehensive and sophisticated compliance regime within WWM.

While we do expect revenue and earnings in the Financial Advisory segment to continue to increase in 2017, we also acknowledge that some investment in technology and people will be necessary over the medium term, and we have plans to bring this about.

Over the past several years, Guardian has had a great deal of success in growing and improving the profitability of its businesses in Canada. Going forward, while we feel that there are still opportunities to succeed in the Canadian market, it is becoming a mature market for us. In order to accelerate our growth in the long term, Guardian plans to continue to invest in our global portfolio management capabilities and, equally important, to continue to invest in expanding our distribution capabilities, in order to seek new clients in Canada, and worldwide. We believe that investing in distribution and continuing to diversify our offering will give guardian an additional opportunity to grow over the longer term.