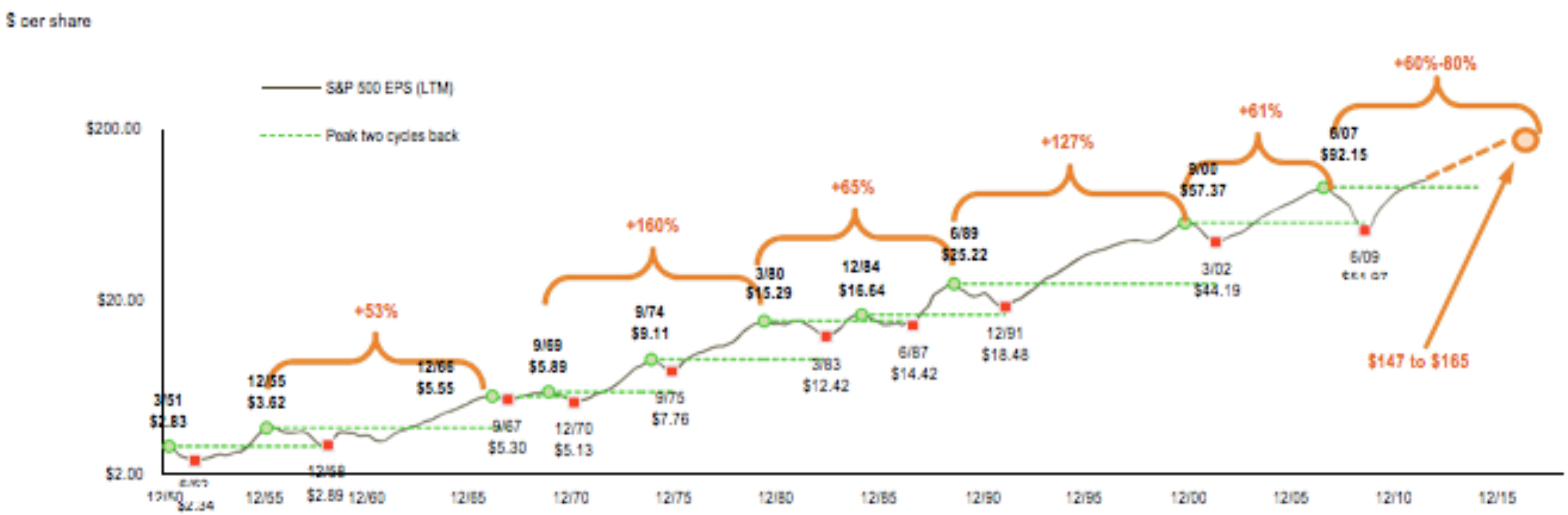
# The Lato Letter – Fall 2012

North American equity markets have just enjoyed a quarter of unexpectedly strong returns and those returns were even better for Padlock's portfolios. A number of macro concerns that were discussed in the previous quarterly commentary continued to play out during the third quarter but North American equity markets looked beyond those concerns and enjoyed robust summer rallies. The underlying support of compelling valuations and very favourable monetary conditions continue to be present.

Over the long term, equities will be driven by their underlying earnings growth on an individual basis and for the market as a whole. Although the earnings about to be reported for the third quarter are expected to show a year over year decline for the first time in several quarters, the earnings recovery from the depths of the 2009 recession is far from over. The chart below, courtesy of JP Morgan strategist Thomas Lee, shows the growth in the earnings for the S&P 500 index for the last 60 years.

From the trough earnings of each cycle, the peak earnings of the following cycle exceeded the prior cycle peak by 50% to 160%, with an average of 93%. Lee uses the 2007 peak earnings of $92.15 and relatively modest growth expectations of 60% to 80% from the previous peak to arrive at a projection for peak earnings of $147 to $165. Should earnings of that magnitude be realized, the level of the S&P 500 even with the most pessimistic view of the price/earnings multiple could be considerably higher than it is today.

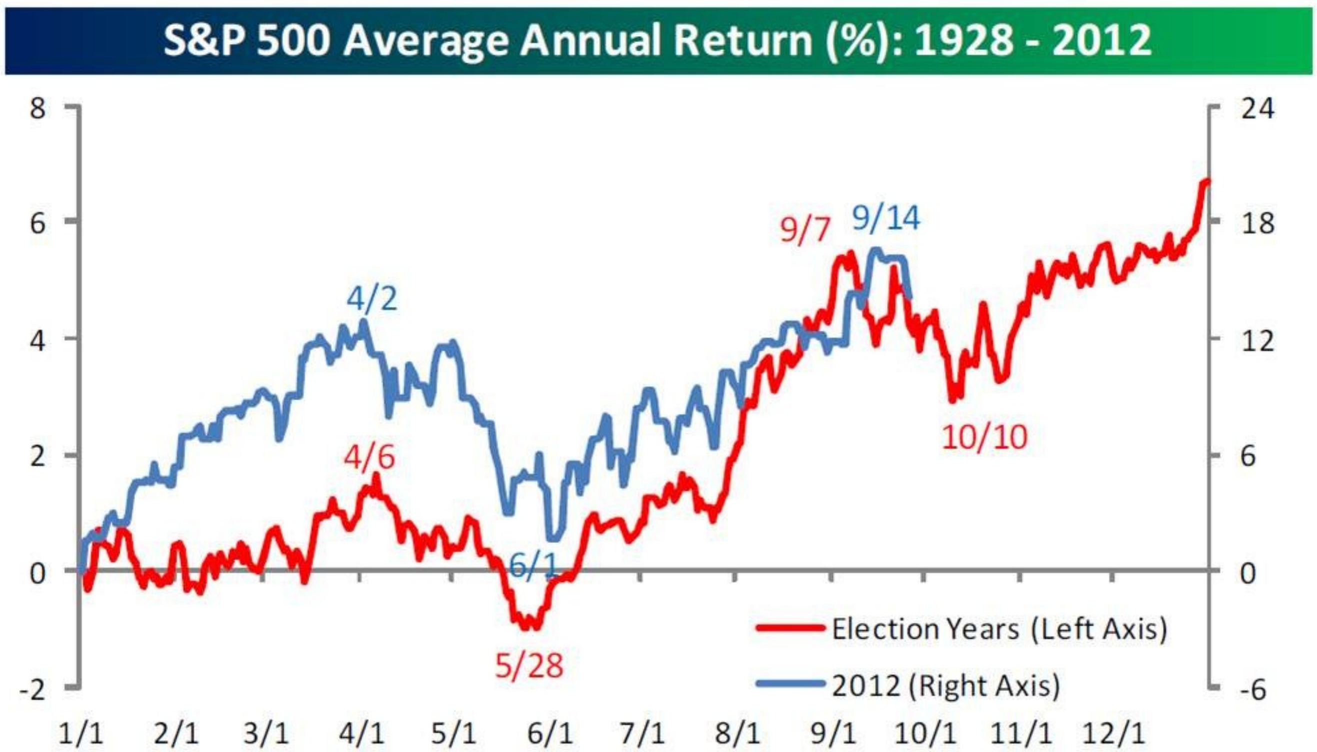
S&P 500 EPS Since 1950...History Suggests Peak EPS Has Exceeded Prior Cycle by 50%-160%



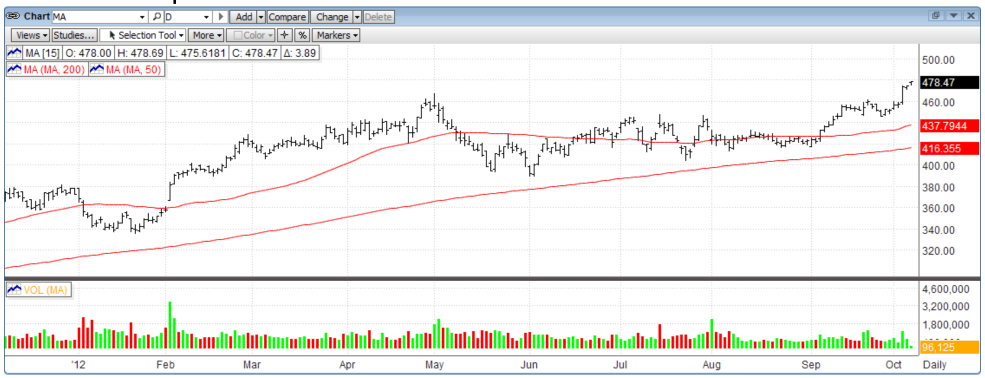

Source: J.P. Morgan, Standard and Poor's.

In the shorter term, those same macro issues have not subsided and investors are also faced with the added uncertainty of the imminent US election. If there is one thing that investors like to avoid, it is uncertainty. However, the closer we get to that November 6th election date the less uncertainty there will be and investors will feel more comfortable about the prospects for the equity markets regardless of the outcome. In addition to the normally positive seasonal factors, US presidential election years have tended to be better years for equities, particularly the latter part of the year.

In the next chart, Geoffrey Saut, the Raymond James strategist, shows the average return for the S&P 500 throughout the year for all election years since 1928 and the return for this year. The average return for all election years is shown in red and uses the left axis, while this year's returns are shown in blue and use the right axis. This year's return has exceeded the average returns but has followed a very similar pattern to date. If history is any guide, it would suggest that equities are well positioned heading into the end of the year.



The most recent addition to the Padlock portfolios is also a former holding.  MasterCard (MA, NYSE -$451.48) was initially purchased in late 2008 in the midst of the financial crisis.  At that time, it was trading at a slightly lower valuation compared to its main competitor, Visa (V, NYSE-$134.28).  Following that initial purchase, the stock performed very well, exceeding the return on Visa.  However, in early 2011, both stocks came under pressure because of impending changes to debit card fees.  Visa suffered more because of its greater exposure to debit fees and was trading at a lower valuation than MA, so MA was sold and Visa was purchased.  As the debit card issue has been digested, the relative valuation of MA was again more favourable and so near the end of the quarter, Visa was sold and replaced with MA.




Among the major attractions of MasterCard is their smaller size compared to Visa and their greater focus on international markets.  MA recently conducted their annual analyst day and reiterated their stated target of 20% annual earnings growth for the next few years.  At a Price/Earnings multiple of 17.6X 2013 earnings (based on the closing price on 09/28/12), MA is above average relative to the market but is still very fairly valued considering the prospects of 20% annual earnings.  MasterCard and Visa have recently reached a Memorandum of Understanding (MOU) to settle litigation with respect to interchange fees that they had charged in the past.  With the sizable settlement soon to be behind them, they will be in a position to utilize their abundant free cash flow to reward shareholders through either share buybacks or increased dividends or both.  As the global economy continues to expand and the secular trend to more and more electronic payments expands, both companies are well positioned for years of growth, but right now, MasterCard is the preferred investment.

As always, when asked for the expected return for the equity markets for the next year, I suggest the average return of 8-10% is appropriate but as I have also stated several times this year, if there is a surprise, I expect it will be on the upside.  With monetary tailwinds and still good valuations, that upside could be fuelled by the hordes of cash on the sidelines re-entering the equity market.