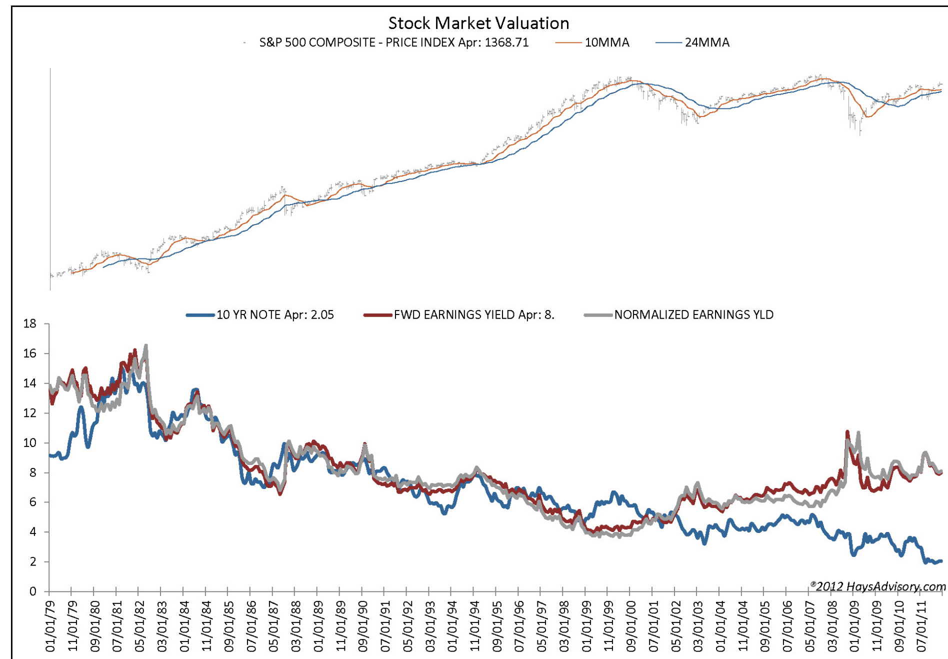
The Lato Letter – Spring 2012

When markets behave as well as they did in the first quarter and many of our holdings outpaced the strong markets, it makes writing the quarterly version of The Lato Letter a much easier job.

Even after the strong first quarter, the valuation of equity markets remains very compelling and with little competition from fixed income investments, I continue to be constructive toward equities. Market sentiment definitely has improved over the course of the quarter but memories of 2008 still linger. Therefore, any lull in positive news or a whiff of macro-economic problems will continue to bring sharp sell-offs, just as we are witnessing in the first couple of weeks of April. Continued earnings growth combined with the very reasonable valuation should mitigate those declines and hence my continued constructive outlook.

The positives in the economy that continue to be somewhat overlooked include an improving housing and labour situation in North America and particularly in the US; bank capital positions are quite healthy again, especially in Canada; corporations, institutions, and individuals continue to sit on large cash hordes and as mentioned above, investor sentiment is improving but is far from the euphoria associated with market tops.



There are still issues facing investors and we cannot be oblivious to them. These issues include improving but somewhat unstable European sovereign entities, relatively slower growth in China, US debt issues and political uncertainty and the economic drag of high oil prices. Although these negatives persist, the underlying positives cannot be ignored in providing great comfort to my constructive stance.

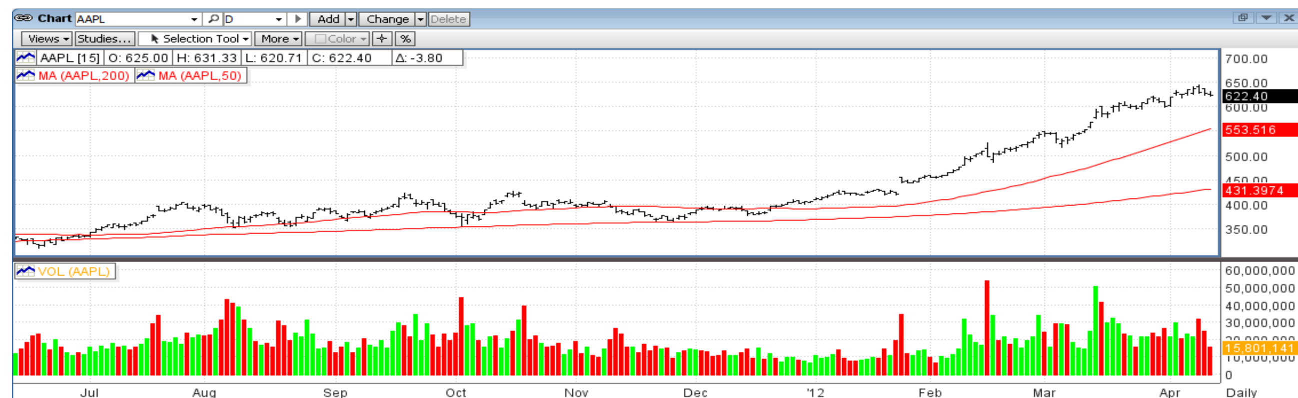
The chart to the right compares the historical yield on 10-year US Treasury bonds to the historical earnings yield of the S&P 500 Index (S&P 500 total earnings/value of the S&P 500 index). As you can see from 1980 to 2002, the

two yields were roughly the same. The yields began to diverge in 2002 and really diverged during the 2008 financial crisis. That divergence has been maintained since then and indicates investors' continued preference for bonds over stocks and general risk aversion. The further we get from 2008, the more likely it becomes that the yields will converge as investors gain confidence and begin to once again favour stocks over bonds.

We have just completed an incredibly strong first quarter and those returns cannot be expected to be replicated in the next three quarters, but expectations for a positive 2012 remain very much intact. As I have mentioned in previous writings, the chances of a positive surprise outweigh those of a negative surprise.

I have written and spoken of Apple (AAPL – NASDAQ,$599.45 on 3/31/12) many times over the last several years, but given the huge contribution that the stock made to the first quarter returns further discussion is warranted. Part of my job as a portfolio manager of relatively "conservative" investment portfolios is to ensure that risks are balanced with rewards. However attractive the stock is – and Apple remains very attractive as evidenced by its still heavy weighting – the overall balance of a portfolio must always be considered. Apple will be reporting its second quarter earnings on April 24th, around the time that you receive this report, and I have decided to maintain positions until that report is released and reassess the holding at that time.

The fundamentals for the company continue to remain very strong. At its price at the time of writing, Apple is trading at a 13.5 price/earnings (P/E) multiple of the current consensus estimate for its September 30, 2012 year end. That multiple is low for the market as a whole and incredibly low for a company with Apple's growth prospects for the next several quarters at least. Backing out the $100 per share in cash brings that multiple down to 11.3 times earnings.



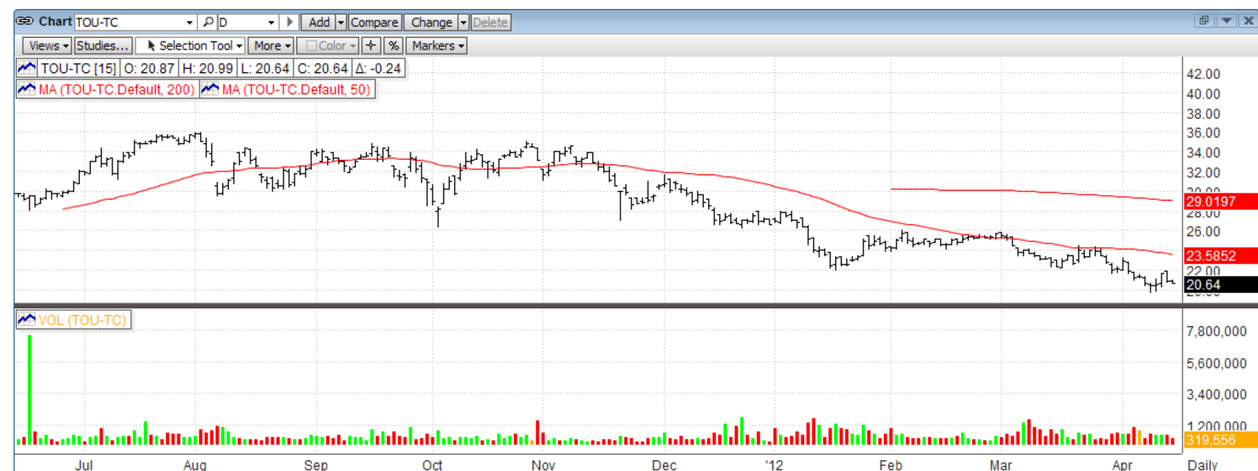
As much as Apple has helped the portfolios, one group that has hurt the portfolios has been stocks with natural gas exposure including the producers and the drilling companies. Natural gas prices have just broken below the $2.00 per million cubic feet (mcf) level for the first time in over ten years and the press is filled with

negative articles, as evidenced by today's (day of writing) headlines: "Gas: prices collapse, Asia awaits" in the Financial Post, and "Natural gas slump hammers producers" in the Report on Business.

The perfect storm of huge shale gas discoveries in the United States and Canada, limited processing and distribution facilities, slower than expected conversion from other fuel sources (coal and oil) and an incredibly warm winter throughout the majority of North America have placed supply and demand totally out of balance. Historically, based on heating equivalents, the price of a barrel of oil should be 6 to 10 times the price of an mcf of natural gas and the current relationship is now an incredible 50 times.

In the short- to medium-term, market conditions dictate prices and so in all likelihood that relationship will continue to be wider than normal for many months to come and there is little the companies can do about it. At some point, the relationship will change as companies continue to shut-in reserves, cut back on exploration for more natural gas and outright fail because the debt that they have taken on to fund previous exploration dwarfs their reduced cash flows. That does not mean that the entire group should be avoided, in fact it means that opportunities in well financed, well positioned and well managed companies with exposure to natural gas and the services that it requires should be acted on.

If I were to pick just one such company it would be Tourmaline Oil Corp. (TOU – TSX, $22 on 3/31/12). In spite of its name, Tourmaline is essentially a natural gas exploration and production company and it fits the above criteria perfectly. The company has doubled its production since its initial public offering (IPO) in November 2010 and subsequent to the end of the quarter it has actually traded below its IPO price for the first time since a few days after the IPO.



Tourmaline is the third major publicly owned oil and gas company created and managed by Mike Rose and his team. The first two, Berkley Petroleum and Duvernay Oil, were both huge successes before being acquired by Anadarko Petroleum and Shell respectively. In fact, since

management and the board control only about 30% of the company, one of their biggest fears is that a third party may make an unwelcome bid to take advantage of the currently weak share price before the company has an opportunity to fully exploit the value of its assets.

Current conditions in the industry will not change overnight but I will be looking at increasing exposure to this group over the next short while through Tourmaline and/or other companies such as Canadian Natural Resources, Peyto Exploration and Canyon Services Group.

Volatility will continue to be present but with valuations providing a great level of comfort, a positive stance with respect to equities continues to be warranted.