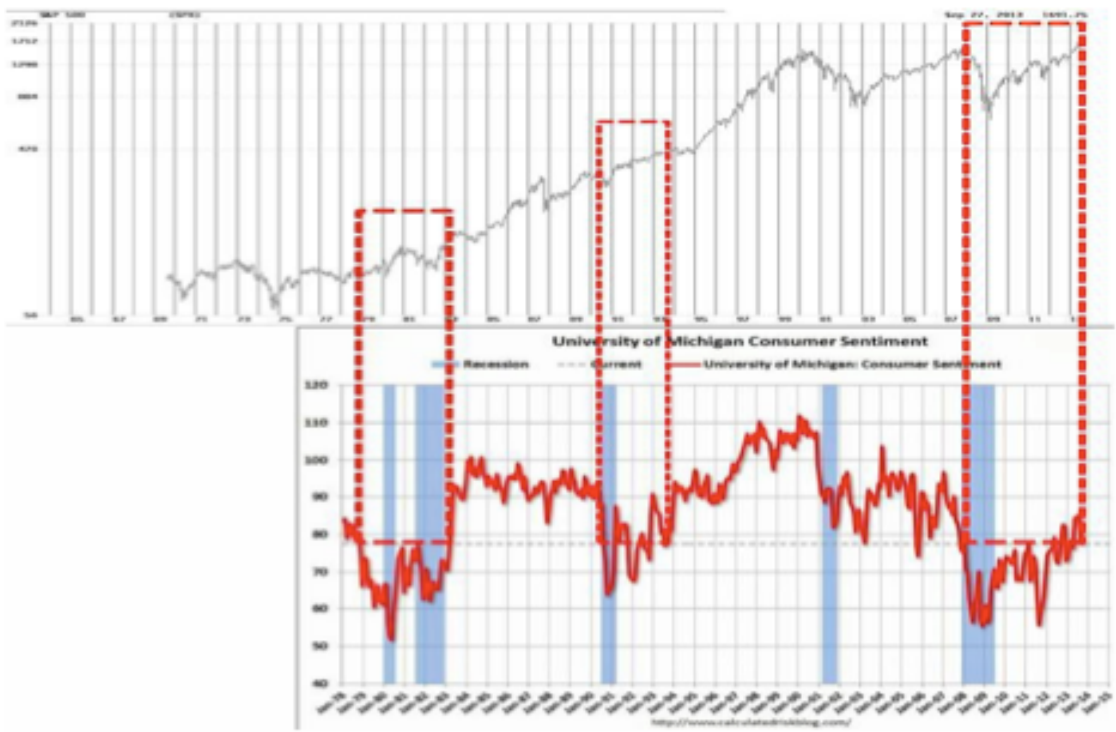
The Lato Letter – Fall 2013

Equity markets were very strong in the third quarter and Padlock's portfolios not only participated in the strength but comfortably outpaced the rise in the markets during the summer months. After faltering in the second quarter, the S&P/TSX Index led by the banks (TD up 9.8%) rallied strongly in the third quarter to once again show a positive return for the year. The S&P 500 Index rose for the third consecutive quarter this year but the gain was somewhat muted by the strength in the Canadian dollar.

The markets and Padlock's portfolios continue to perform well and my constructive outlook for the next year remains unchanged. We all know what the headlines are blaring (the US government shutdown and pending default), but underlying those issues – which may or may not be resolved by the time you read this commentary – is a bull market which potentially has several months if not years to run.

The chart below (courtesy of Hays Advisory) takes a long-term look at the relationship between the S&P 500 Index and the mood of the investing public, as measured by the University of Michigan Consumer Sentiment Index (UMCSI).



The dash-lined box areas capture the periods since the late 1970s where the UMCSI was below 80% for an extended period of time. In all three cases of consumer pessimism, 1978 to 1983, 1991 to 1994 and 2008 to 2013, the S&P 500 was modestly positive as equity markets climbed the proverbial “wall of worry”. The two periods prior to the current period of pessimism were followed by multi-year and substantial increases in the S&P 500.

Yes, it could be different this time but valuations in the equity market remain very favourable as do monetary conditions. The Federal Reserve’s “punch bowl” will be taken away at some point but only with continued strength in the economy which should lead to increased earnings to support reasonable valuations at even higher prices.

I have certainly been pleased with the performance of the portfolios this year, particularly when you consider that the largest equity holding, Apple (AAPL-NASDAQ, $476.75), is down 10.4% year-to-date and 28.5% since the end of the third quarter last year. After years of being the easiest stock to hold in the portfolio, Apple has been the most difficult stock to hold for the last 12 months.

The recent news about the company and the “technical” action of the stock suggest that is about to change for the positive. Technically, the stock price has broken through its 20 day, 50 day and 200 day moving averages to the upside and has broken the downtrend in prices starting last September.

From a company perspective, the recent releases of the iPhone 5S and 5C have been extremely successful in spite of the initial negative reaction of the analysts that follow the stock. What was far more telling was the extremely strong reviews that the phones received from the consumer technology analysts including the highly regarded Walt Mossberg of the Wall Street Journal and David Pogue of the New York Times.

Those positive reviews foreshadowed a record breaking first weekend of sales which will help the third quarter results to be reported in late October. Additionally, the company has been in conversation with renowned investor Carl Icahn concerning the use of their large cash reserves. It will certainly be interesting to see how many shares of the stock were purchased for cancellation during the last quarter. Since the cash is providing a minimal return and the stock is trading at such a low price/earnings multiple, every share purchased is accretive (positive) to earnings. This accretion is the premise of Icahn's argument. Personally, I believe Apple can do more but I do not feel that they would be wise from a long term perspective to fully embrace Icahn's suggestion of buying back $150.0 Billion of stock.

Nonetheless, after a year of finding reasons not to own Apple, I believe that sentiment is now becoming more favourable and could lead to a re-valuation of the company. After a year of not carrying its weight in the portfolios, Apple is poised to once again lead the portfolios higher.

While Apple, in spite of the last year, has been the foundation of the portfolio and most easily understood as to its inclusion, the most speculative holding in many portfolios (not all) and least understood, has been Sears Holdings (SHLD-NASDAQ, $59.49). Padlock follows a "Growth At Reasonable Price" (GARP) methodology but Sears Holdings is definitely an exception.

Sears Holdings is not part of the portfolios because of its earnings growth because it hasn't had any earnings for years. Nor is it included because of its strengthening retail business because it continues to flounder. Sears Holdings has been included because of the potential re-engineering of the company by its chairman and largest shareholder, Eddie Lampert.

Mr. Lampert has significantly raised his personal stake in Sears Holdings during the last 18 months and has begun to realize some of the underlying value of Sears Holdings through both spin-offs of divisions and sales of its real estate assets. A recent report by the investment group Baker Street Capital Management highlighted that the value of that real estate served as a catalyst for the recent move in the stock since early September. If you are interested in a copy of that report, please request a copy and I will send it to you.

The report discusses the various ways available to Sears Holdings to realize that value, some of the recent initiatives by the company to do so, and then suggests a potential value approaching $200 per share. Many things would have to go right for this to happen, including a continued resurgence of the US economy but the possibility exists and thus that possibility becomes the primary reason for its inclusion as a speculative holding in many portfolios.

In summation, although the minor correction that we are currently in the midst of may persist in the short term, Padlock remains very constructive toward the equity markets and comfortable maintaining its equity exposure in anticipation of another solid year of gains.