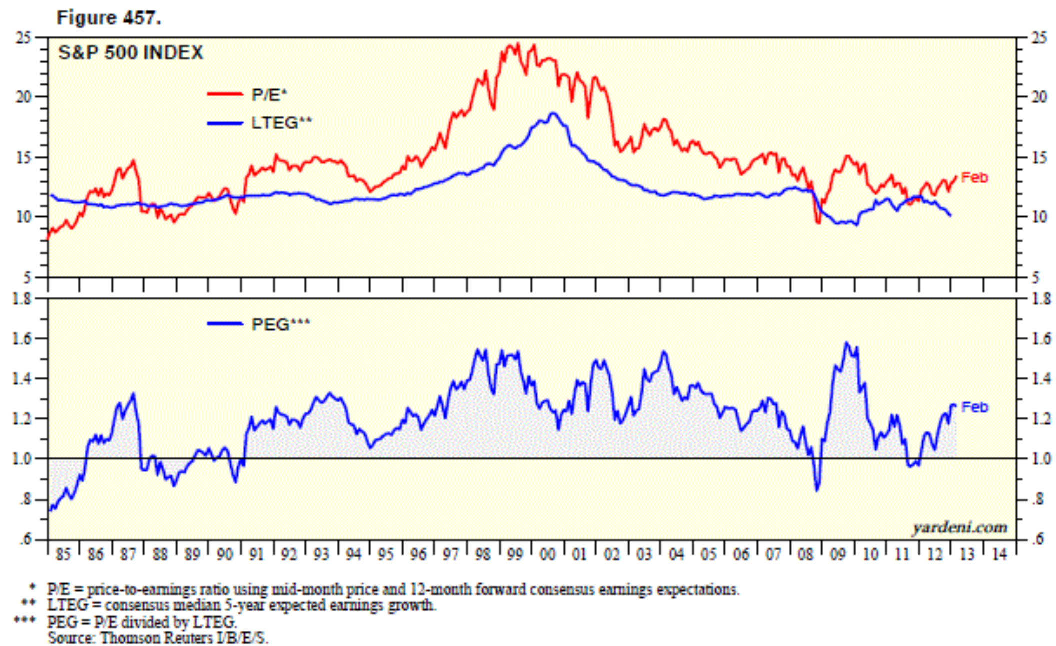
The Lato Letter – Spring 2013

In the first quarter of 2013, the improved psyche of investors allowed equities to reclaim their spot as a favoured asset class. Slowly but surely investors' scars from 2008 and 2009 continue to fade as they embrace a normal investing environment. US equities as measured by the S&P 500's 10% return greatly outpaced Canadian equities, but the 3% plus return for the S&P TSX index is also well above historical norms. It was another solid quarter for Padlock's clients as the balanced, growth and small cap composites all exceeded their benchmarks.

Although psychology is important in determining the future course of the market and cannot be ignored, over the long run it is earnings and the relation of the stock price to those earnings that drive investment returns. As you can see from the following chart courtesy of Yardeni Research Inc., in spite of the now four year old bull market, equities as measured by their P/E (Price/Earnings) ratio are far closer to the trough levels of the last 30 years than they are to the peak levels. More importantly, even with the lower long term earnings growth expectations of analysts, the PEG ratio (described in the next paragraph) is essentially right in line with its 30 year average.

The PEG ratio, which is one of the core valuation measures used by growth investors (Padlock included), is the ratio of the P/E multiple to the expected earnings growth rate. The lower the PEG ratio the more attractive the stock is from a valuation perspective. Padlock tries to identify companies that have average or above average growth rates while at the same time are trading at below average PEG ratios. The companies must also be fundamentally sound and not fully reflecting the future prospects of their business, thus creating the opportunity for above average returns.



Two US stocks have been added to clients' portfolios over the last several months that possess these attributes. **NCR Corp (NCR-NYSE, $27.56)** began its existence as the National Cash Register Company over 130 years ago and in its latest form as NCR Corp was added to clients' portfolios in November of last year. Moving beyond cash registers to ATM machines and Point-of-Sale (POS) terminals, NCR has embraced technology to become a leading player in both of these industry segments.

These two segments have rather moderate growth prospects and what is not reflected in NCR's valuation is the company's diversification beyond these segments. Aided by a couple of acquisitions in the last few years, NCR has evolved into a more diversified hardware, software and service company.

Quoting a recent JP Morgan research report, "NCR, often wrongly categorized as a pure-play ATM/POS supplier, is now a diversified supplier of technologies that transform the way in which consumers connect, interact and transact with businesses, across online, mobile and physical retail channels. NCR deserves a growth multiple……"

The analysts' consensus estimate for 2013 earnings for NCR is $2.71 growing to $3.07 in 2014. At P/E multiple of 10.2 times this year's earnings and projected consensus long term growth of 14.80%, NCR is valued at a PEG ratio of 0.69 compared to the 1.21 average in the chart of the S&P 500 PEG ratio shown above. Truly compelling value in a well-managed company poised to reward shareholders.

The other company that was added to clients' portfolios just a few weeks ago is **Dick's Sporting Goods (DKS-NYSE, $47.30).** Dick's was created in 1948 when Richard Stack borrowed $300.00 from his Grandmother to open his first store in Binghamton, NY. Dick's now operates over 500 stores in 44 states under the Dick's name and over 80 Golf Galaxy stores.

Dick's was a stock that had been on the radar screen for a while and just prior to Padlock establishing a position for its clients in March, Dick's reduced their earnings guidance for 2013 and the stock sold off dramatically. The guidance was reduced for a number of reasons that included decreased outlook for the Lance Armstrong line of fitness equipment (no surprise there and no further comment necessary), weather (having a wife in the fashion business www.yesvirginia.ca, I can attest that weather is indeed a factor) and most importantly increased spending on store remodeling, new store testing and an increase in the pace

of establishing "shop in shops" with Nike, Under Armour and Adidas. This increased investment spending should lead to increases in future revenues and earnings.

Again, to quote a JP Morgan report written a couple of days after the announced guidance reduction, "All in, while spending is higher, we believe that guidance also includes an element of prudence and would use the <u>exaggerated</u> move in the stock yesterday as a buying opportunity." The current consensus estimate for this year is a reduced $2.86 but growing to a consensus estimate of $3.31 for next year. With long term earnings growth projected to be 15.39%, the PEG ratio on this year's earnings is an attractive 1.07 but a very attractive 0.93 based on next year's earnings which are predicated on Dick's return to its historical growth rates.

The two holdings discussed above are indicative of the opportunities available within the equity market and form part of the logic for remaining constructive on equity markets for the balance. First quarter returns have certainly exceeded expectations and some short term caution might be warranted but as I stated in last quarter's report, if investors are going to be surprised this year, it will be an upside surprise as investor psychology continues to improve, central banks remain accommodative and valuations are still very reasonable.