The Lato Letter – Summer 2013

The bull market that started in March 2009 continued into its fifth year in the second quarter of 2013 and Padlock's portfolios were well positioned for it. The second quarter was certainly more difficult in the Canadian equity market as gold stocks (fortunately we don't have any) led the S&P/TSX index to a decline for the quarter. The decline in the Canadian equity market was more than offset by the continued rise in the US equity market and Padlock's US holdings.

Since the start of the bull market in the US, there have been three corrections (defined as a 10% decline) but no 20% declines that define a bear market; although as you can see from the chart below, we came very close in 2011.

One can certainly argue that we are overdue for a bear market but history does not bear that out (pardon the pun). Dr. Ed Yardeni of Yardeni Research recently wrote an excellent piece reviewing the intervals between bear markets with respect to duration and number of corrections during the interval. In summary, in the post WW2 period his findings were as follows in the table below.

Bear Market Interval (as measured from the end of 1st to beg. of 2nd)	Duration	Number of Corrections
2002 to 2007	5 years	One
1987 to 2000	12.5 years	Two
1980 to 1987	5 years	One
1974 to 1980	6 years	Six
1970 to 1973	2.5 years	Two
1966 to 1968	2 years	One
1962 to 1966	3.5 years	One
1957 to 1962	4.5 years	One
1949 to 1957	8 years	Three
1946 to 1948	2 years	Two

His conclusion, and one that I happen to agree with, is that the current bull market is not atypical and that given the current combination of valuation, earnings growth, monetary conditions and market sentiment, the bull market could extend another four years unless a market melt-up occurs before then. I have alluded to the melt-up scenario in previous writings and although I do not suggest that it will happen, it certainly cannot be ruled out.

As always those market rewards are derived from owning solid, well-managed companies with the potential to grow their earnings, and are purchased and held at a valuation that is not entirely reflective of their future growth potential. One of those companies, Cognizant Technology Solutions (CTSH-NASDAQ, $62.64 on 06/30/13) was recently added to the US equity holdings in most portfolios.

Cognizant is a leading provider of information technology, consulting, and business process outsourcing services. The company, originally a division of Dun & Bradstreet, has had a long history of high-teens earnings growth and – as judged by the analysts following the stock – is expected to continue to do so. The stock has come under pressure recently due to proposed changes in US immigration law that could have an unfavourable impact on Cognizant's outsourcing business. As we have seen in the past, changes in government regulation have had an impact on stocks such as MasterCard and Shoppers Drug Mart (more on that later). But, strong companies adapt their business models and continue to capitalize on opportunities available to them to continue to grow their business, while the stock price decline associated with the impact of the new regulations presents a great entry point. I believe that is the case with Cognizant which has recovered some of its earlier losses as the uncertainty concerning the regulations dissipates.

As I was putting the finishing touches to this commentary, the news of the acquisition of Shoppers Drug Mart (SC-TSX, $48.52 on 06/30/13) by Loblaw Companies was being announced. Shoppers, which some clients have owned from its initial public offering (IPO) price of $18.00, has always been a very well-managed company that did suffer for a

couple of years as provincial governments in Canada changed their payment structure to pharmacies. So, it was with somewhat mixed emotions that we greeted the news.

After enduring a couple of years of stagnant earnings, the company was poised to resume its earnings growth and WAS still being valued by the market at a very reasonable price that I felt did not reflect its future prospects. I guess the management of Loblaw agreed with me because they offered a substantial premium to the recent trading price of Shoppers. I am delighted for my clients who will enjoy the premium price being paid for the shares, but slightly sad to lose a great company from the portfolio that still had many good years ahead of it. Ultimately though, that is what a portfolio of stocks is there to provide: a reward for investing in a business whose true value will surface in one way or another over time. Although the offer is a combination of cash and stock, I will most likely be selling the holding prior to the completion of the deal and the receipt of the Loblaw shares.

As always, there are concerns about the markets in the news (the current focus being the end of the Quantitative Easing or QE) but the current market conditions still suggest that exposure to equities and particularly the equities in the Padlock portfolio should provide positive returns.

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