The Lato Letter – Winter 2013

Padlock has just celebrated its first anniversary with a very successful year for its clients. The US exposure in the portfolios was very beneficial as the US/CDN exchange rate was relatively stable throughout the year while the US equity market was well ahead of its Canadian counterpart.

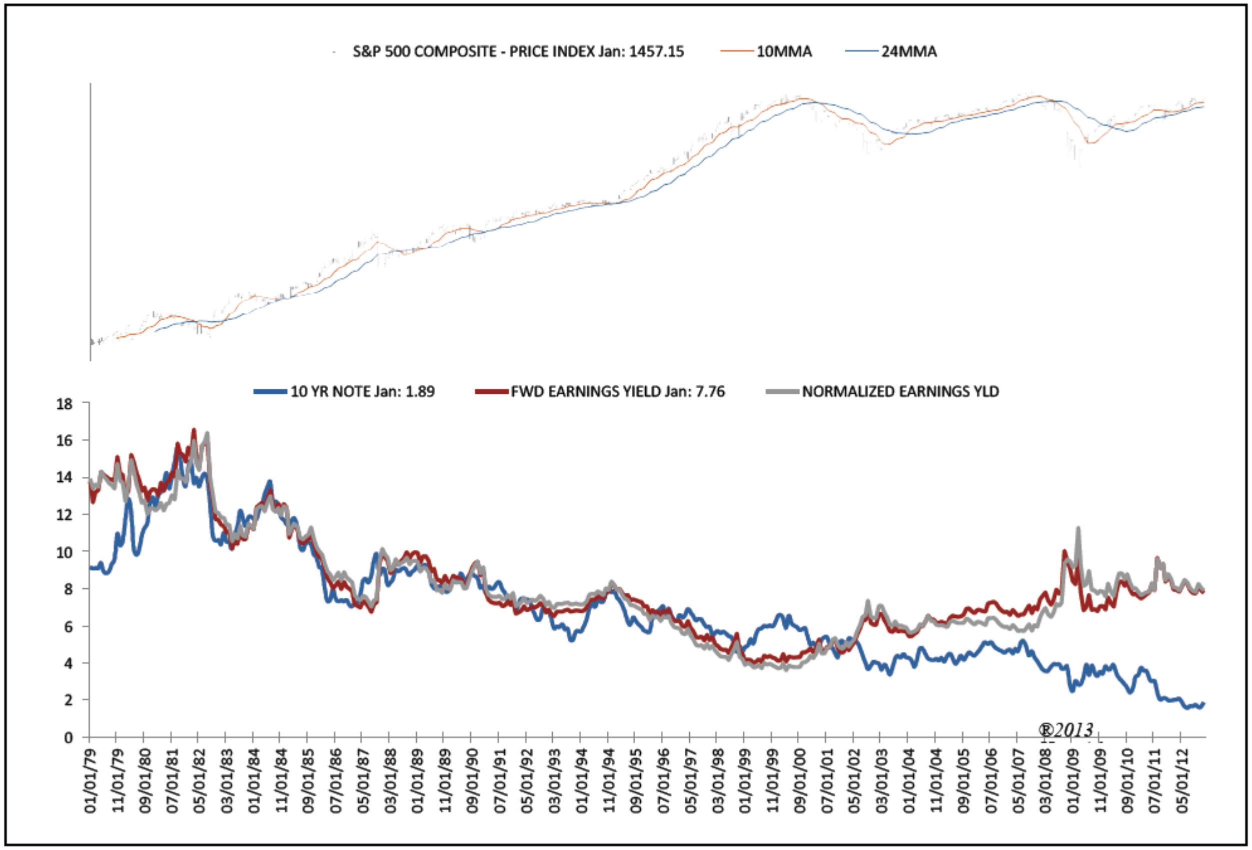
As we head into 2013, the dominant headline issues of the fourth quarter, the US election and the US fiscal cliff, have been put to bed. The resolution of those issues was perhaps not the most ideal solution for the equity markets as the US debt issue was simply pushed further down the road without the necessary pain required to solve it. In spite of the difficult macro issues of 2012, the market maintained its strength due to the favourable underlying fundamentals. We will continue to focus on those underlying fundamentals as we assess the equity market in 2013.

Valuation remains extremely appealing and monetary conditions remain conducive to favouring continued investment in equities. Although there have been four consecutive years of positive returns for the S&P 500, bear markets have historically not started until monetary conditions turn negative. The old adage of “the party doesn’t end until the Fed takes the punch bowl away”, is an adage worth heeding at this time.

Given the all-time low level of interest rates and the inevitable rise in rates that will occur, I believe that at this point, there is far more downside risk in the bond market than there is in the equity market. As interest rates rise, bond prices will fall and the decline in value from these levels will exceed the meager interest income that bonds currently provide. For this reason, for Padlock’s balanced accounts which have a mandated exposure to fixed income, the maturities are being kept very short to minimize the risk to the capital allocated to fixed income.

Given the two alternatives of the bond market and cash that basically provides no income, exposure to equities is necessary and favoured to generate positive returns in 2013. The familiar chart below once again shows the discrepancy between fixed income yields and the “earnings yield” of the S&P 500 (earnings yield is the inverse of the Price/Earnings ratio). The gap between the two lines began to widen prior to the 2008 financial crisis and the devastating blow that investor confidence endured at that time has yet to be overcome. At some point, now four years later, that confidence will return and the current four year old bull market will enter its final stage.

Stock Market Valuation



The legendary investor, John Templeton, was quoted as saying "Bull markets are born on pessimism, grow on skepticism, mature on optimism and die on euphoria." Markets were certainly pessimistic in 2008, remained skeptical throughout 2010 and 2011, became a little more optimistic last year but are certainly nowhere near euphoric. With the economy continuing to show signs of improvement in North America along with a sense of renewed optimism in China and the threat of fiscal cliff recession seemingly off the table, the market has time for investors to build up their optimism before euphoria potentially takes over.

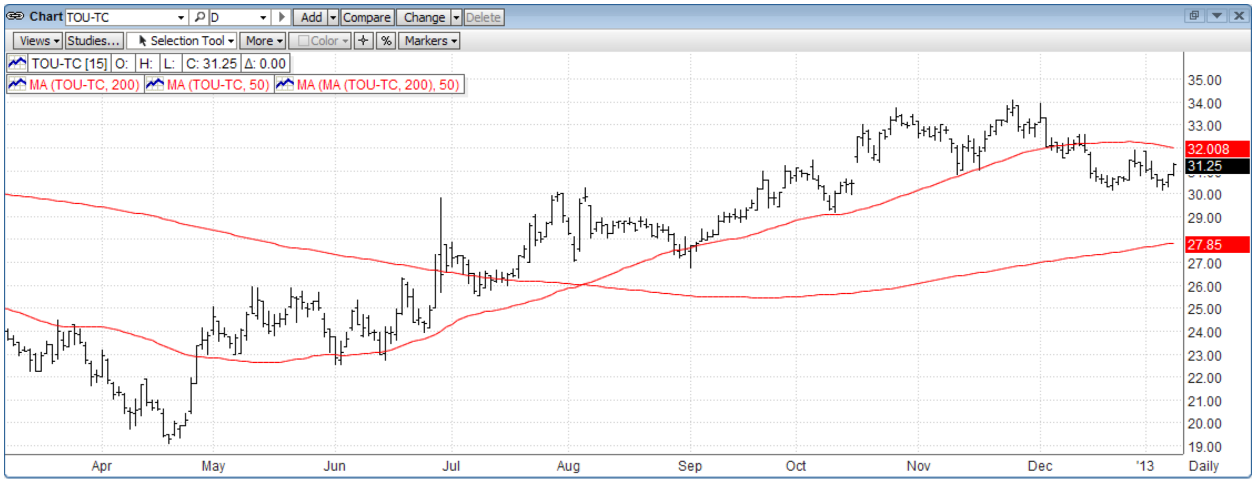
The main blemish in the portfolios last quarter was the decline in Apple (AAPL – NASDAQ, $532.17). After an absolutely spectacular start to the year, this stock seemingly went from the optimism stage to the pessimism stage during the course of the last quarter without passing through euphoria.

The bears will argue that at its high of $705, Apple was indeed euphoric but I would counter that even at that price, based on last year's earnings of $44.16, a Price/Earnings multiple of 16.0 times can hardly be described as euphoric. At the end of 2012, that multiple is down to less than 11.0 times the current consensus estimate for 2013 of $48.69; a very compelling valuation.

Although a single set of quarterly earnings should not be the basis of the long term value of any company, the upcoming earnings release scheduled for January 23rd will be a major determinant of whether pessimism continues to be the dominant emotion for this stock. With the recent introduction of two major products, the iPhone 5 and the iPad Mini, with product margins being impacted by these and other new releases, with supply constraints perhaps limiting sales and with a more competitive industry environment, the range of estimates for the quarter are extremely wide. The estimates currently range from $11.53 (below Apple's guidance) to $15.50 with an average estimate of $13.34.

Apple is still a company that produces incredible products that continually get better and enjoys a huge ecosystem that ties its customers to those products for many years. The strength of the ecosystem is exemplified by the 20 billion downloads last year which doubled the number of downloads since the creation of the App Store in 2007. Apple's future earnings growth cannot be expected to approach the 50% plus annual growth rate of the last two years, but the entrenched renewal program embodied in the strength of that ecosystem combined with the continued evolution of new and better products serves as the basis for earnings growth in the future and a return to a Price/Earnings multiple that reflects a more optimistic outlook for this great company.

Apple remains the heaviest weighting on the US side of the portfolios, and the heaviest weighting on the Canadian side is Tourmaline Oil (TOU- TSX, $$31.23). In spite of the S&P/TSX Oil and Gas Index having a negative return in 2012, Tourmaline's return was a very healthy 17% in 2012. Even more fortunately for Padlock's clients, we added to the position early in the year at just over $20.00 per share as the stock bottomed with the low in natural gas prices that was seen in the first quarter. Although the company has "oil" in its name, it is predominantly a natural gas producer.



With new supplies of natural gas coming on stream in the United States, the pricing for natural gas will remain challenging. However, because of one of the lowest cost structures in the industry, its excellent balance sheet and vast acreage and potential well sights, Tourmaline is in a far better position than most of the industry to continue to enjoy healthy production and cash flow growth in 2013. From 18,000 boe/day of production in 2010, the year of its initial public offering (IPO) to 31,000 boe/day in 2011 and over 50,000 boe/day in 2012, based on its planned capital expenditure program the company has provided guidance for production approaching 75,000 boe/day in 2013.

Obviously, it takes more than two stocks to build a portfolio and although I have once again highlighted these two stocks, there are many great companies and compelling stocks in the Padlock portfolios that are also well positioned to positively impact our returns in 2013. I continue to remain constructive on the equity market and in particular on the stocks that are included in the Padlock portfolios.

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