The Lato Letter – Summer 2014

The bull market that we have enjoyed since 2009 continued unabated during the second quarter with all of the major North American large cap indices setting new all-time highs. Padlock's portfolios also continued to perform during the quarter surpassing their benchmark returns once again.

Although the last few quarters may seem that way, not all stocks go up all of the time. In addition to having exposure to rising markets, the objective of portfolio management is to have holdings that more than carry their weight at certain times when other holdings may not be faring as well. During the last quarter, the significant exposure to oil and gas related holdings had a very favourable impact on the Padlock portfolios. The exposure to oil and gas has come in many different ways with the one common denominator being the respect for the management teams that run the various companies in the portfolios.

I would like to highlight four very different oil and gas related companies that anchor the oil and gas portion of the portfolios and continue to have, what I feel, is above average potential beyond the returns that they have already provided. The four holdings are Canyon Services Group (FRC-TSX, $18.90) a pressure pumping services company operating only in Western Canada; Hi-Crush Partners LP (HCLP-NADAQ, $65.56) a fracking sand producer serving the US exploration companies; Parex Resources Inc. (PXT-TSX, $12.55) a Canadian based exploration company now operating exclusively in Columbia; and Tourmaline Oil Corp. (TOU-TSX, $56.26) an exploration and development company also operating only in western Canada.

Here are the "two-year" charts of the four companies and as you can see they have enjoyed great success and have been huge contributors to the portfolio performance over the last two years and particularly in the last quarter:

Canyon Services Group

Hi-Crush Partners LP

Parex Resources Inc.

Tourmaline Oil Corp.

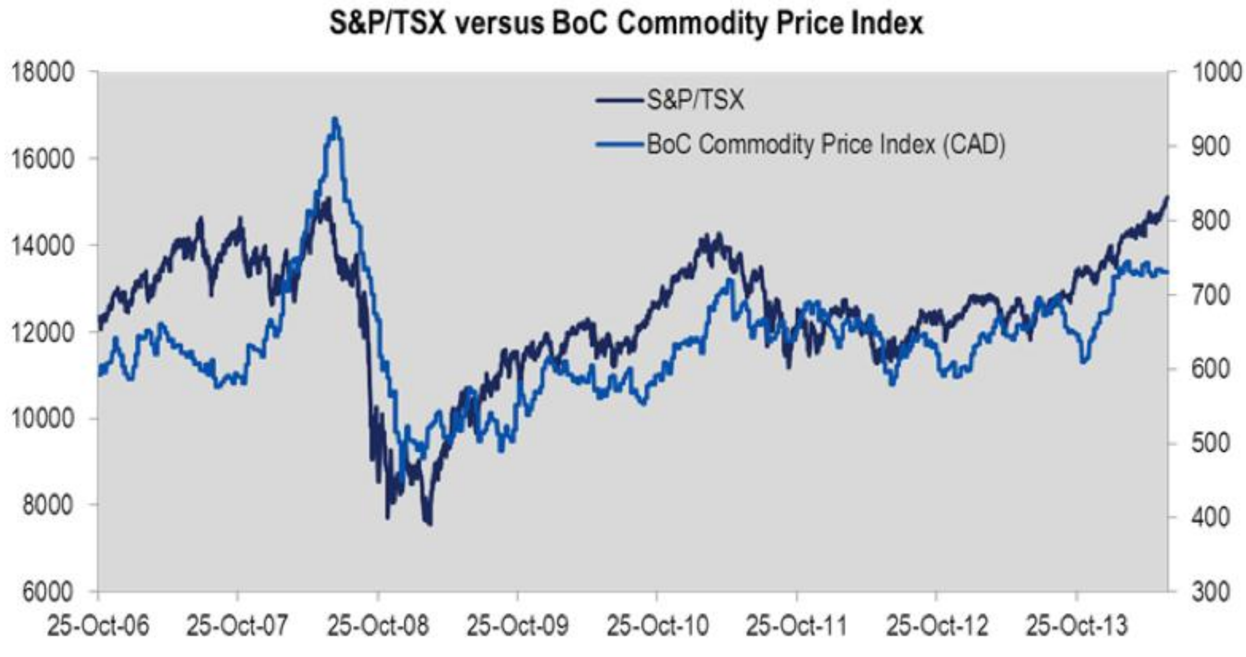
Higher prices for both oil and natural gas have been contributors to the rise in share prices during the second quarter but the attractiveness of these companies goes well beyond higher commodity prices.

I am in the midst of reading an interesting book entitled “Unleashing the Second American Century” by Joel Kurtzman. The book discusses the four reasons why America will follow the 20th century known as the American Century with a second great century (although written from a US perspective, I believe it is fair to say that North America can be substituted for America). One of the four reasons is that North America will become energy self-sufficient because of the technological advances that have been made in oil and gas exploration, particularly the use of fracking.

Fracking is the short name for the process of “high-pressure hydraulic fracturing of rock” which, quoting from the book, “has advanced to the point that these once unobtainable reserves of energy can now be extracted quickly, easily and profitably.” Canyon and Hi-Crush are part of the fracking process that allows the exploration companies like Tourmaline and Parex to very profitably produce much larger quantities of oil and gas from their properties and thus all reward their shareholders. There are obviously many ways to participate in this secular trend but at the end of the day, well-managed companies that are still reasonably priced compared to their future prospects are great businesses to own as a shareholder. The four companies highlighted above clearly fall into that category.

After such a strong move in the group, the obvious question is whether or not the group has run its course and will be subject to a major correction. The answer to that question is that a correction in the group is a possibility but that the positive long-term outlook of these companies outweighs the risk/reward of taking profits and exiting the group. As you can see from the chart below (courtesy of BMO Capital Markets), the S&P/TSX Index tends to trade in line with the Bank of Canada Commodity Index but has recently slightly outpaced the Commodity Index.

Corrections are part of every bull market and it has been several months since the current bull market has seen a correction; as defined by a 10% decline. I believe that investors' continued focus on looking for the next correction is a major contrarian reason for remaining constructive. As you know, Padlock has always taken a bottom-up, stock selection approach to managing your portfolio by investing in well-managed companies with reasonable valuations and continued growth prospects. The four companies discussed above and the remainder of the holdings continue to fall into that category.



Source: BMO Capital Markets Investment Strategy, FactSet, Bank of Canada.

Profits will be taken when dictated by portfolio weighting considerations, valuations becoming excessive, the underlying business fundamentals of a company changing or as a source of cash for a better opportunity that is not currently in the portfolio. Profit taking for the sake of taking profits is not a sound strategy for the optimum long-term growth of your portfolio.

In summary, I believe that markets remain positioned to reward investors and that the current portfolio holdings at Padlock continue to be attractively priced businesses that should enhance those rewards.