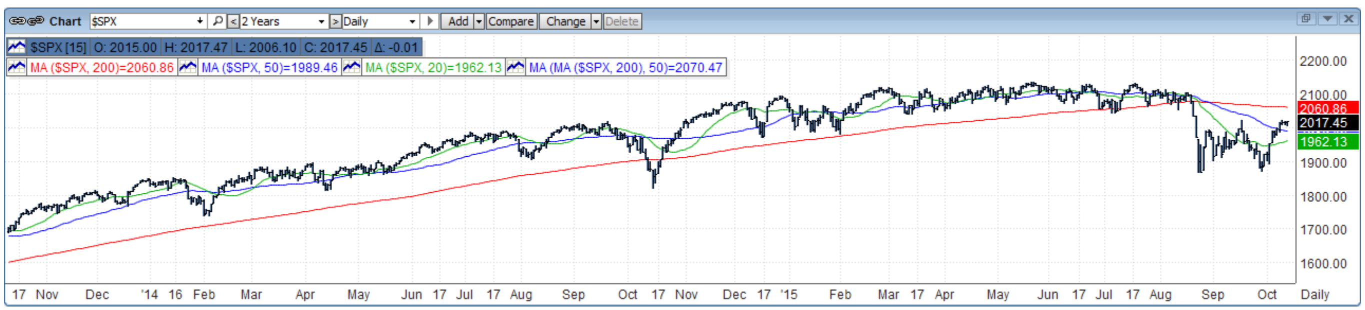
# The Lato Letter – Fall 2015

The third quarter of 2015 was a great quarter for the Toronto Blue Jays. The North American equity markets did not fare quite as well. Although the earnings reported early in the quarter generally met or exceeded overall expectations, markets dipped due to the macro-concern that had been percolating through the markets for several months. One quarter does not alter Padlock's long term view to continue to be constructive on equity markets into the fourth quarter and next year.

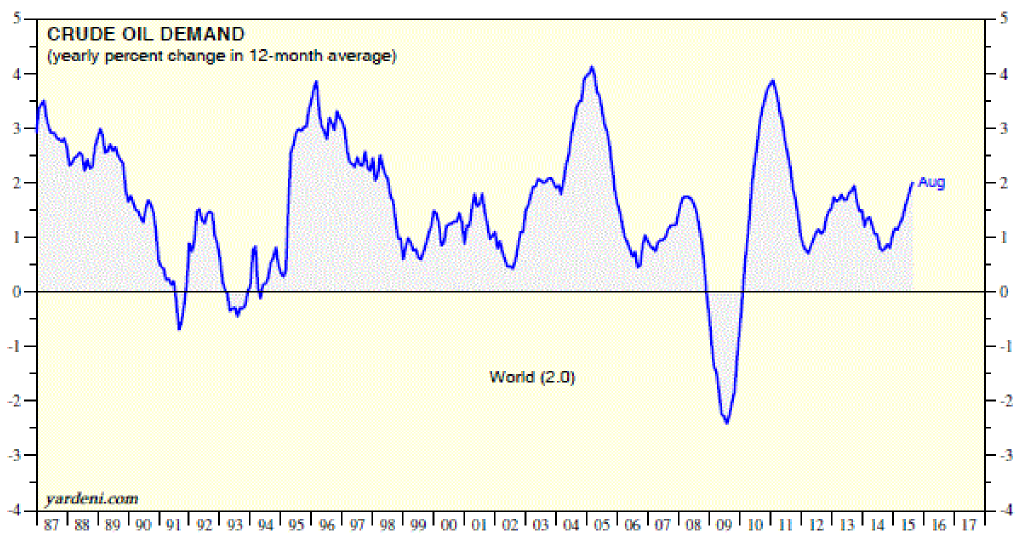
While markets softened, the narrow trading range of the S&P 500 Index (see below) that dates back to early 2014 remains intact. Since mid-April of 2014, the S&P 500 has traded in a range of plus or minus 6.7% around a mid-point of 1995, closing the 3rd quarter about 4% below that midpoint (but at the time of writing was back above the midpoint).

**S&P 500 Index**



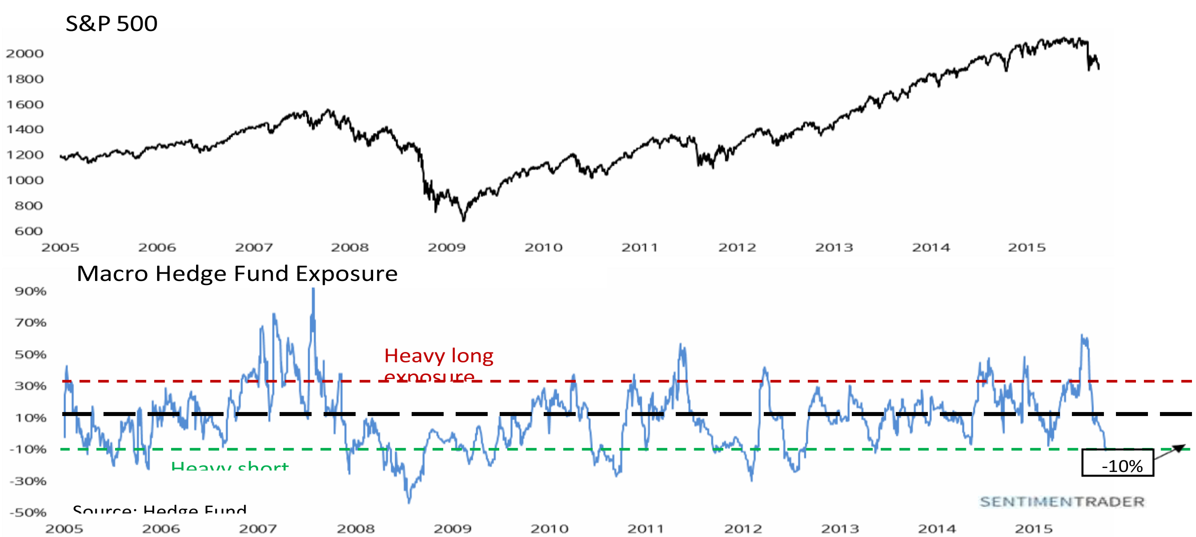

The macro concerns may persist but as we approach the end of the year, the economy, particularly in the US, continues to look solid. The Canadian economy is obviously far more impacted by weak commodity prices but the performance of the non-resource companies in the Padlock portfolios acted as a strong counter balance to the resource holdings in the portfolio.

The resource holdings have underperformed over the past year but there are some encouraging signs suggesting that the recent lows in the price of oil could have marked the bottom.  The following chart from Yardeni Research shows the monthly percentage change in global oil demand.




Source: Oil Market Intelligence.

As the chart suggests, August's 2.0% increase was the biggest year over year increase in demand since 2011. Clearly the old adage of "the best remedy for low oil prices is low oil prices" is beginning to take hold which should benefit the energy holdings, which with exception of the service companies, have actually performed reasonably well during the year.




With what appears to be a further delay in the ultimate increase in interest rates in North America, equities continue to present the most favourable risk/reward parameters among the two major asset classes. It is quite interesting to note that in spite of relative attractiveness of equities and after the market has corrected over 10% from its high, US hedge managers have their lowest equity exposure since 2013. This chart from Sentiment Trader (a new service that Padlock has subscribed to) shows that their net exposure is approaching the lowest levels of the past decade. There are many hedge fund managers that are shrewd traders and do very, very well but as a group, herd mentality does tend to prevail and the lowest levels of net exposure have tended to occur around market bottoms.

As you know, in spite of discussions of market levels and the always present up and downs of the market, Padlock manages its portfolio without tremendous concern of the day-to-day fluctuations in the equity market. The focus is on buying and holding solid businesses that are undervalued to fairly valued. One of those businesses that was added to the portfolios during the quarter was Sleep Country Canada Holdings (ZZZ-TSX, $15.25).


From 2003 to 2008 many of the current Padlock clients held Sleep Country Canada Income Trust, the publicly traded entity that owned Sleep Country, the mattress retailer. In 2008, a private equity firm, Birch Hill Equity Partners, purchased the income trust at a value of $356 Million, providing a total return of 218% to the initial investors.

Under the stewardship of the management team that was retained, Sleep Country continued to grow under Birch Hill. Early in the last quarter, Birch Hill decided to capture some of that growth and filed a new IPO for Sleep Country, in a corporate form this time. The IPO was fairly aggressively priced at $17.00 per share and the stock quickly settled into the subsequent range of roughly to $15.00 to $15.50.

Mattress retailing is a very stable, slow but steady growth business that is led in Canada by Sleep Country, with its 23% market share. Using US industry data as a proxy, mattress retailing has grown by 6.1% per year for the last 40 years and growth of that magnitude is expected to continue. With Sleep Country’s leading and growing market share, it is well positioned to increase mattress revenues by a similar magnitude and augment that growth with its initiative into growing mattress accessories sales. Birch Hill continues to own almost 46% of the shares outstanding and will no doubt be looking to realize further gains on its investment at higher prices over the next few years.

In spite of the difficult quarter, Sleep Country has held its own from the time of its inclusion in the portfolios.  Currently trading at approximately 15.0 X next year's earnings (a discount to its North American peers) and with a dividend yield of just under 3.0%, Sleep Country is well positioned to provide excellent returns to its new shareholders.

The long term performance of Padlock's portfolios is going to be far more dependent on holding great businesses that continue to grow and reward their shareholders over the long term than it will be on the shorter term vagaries of the market.  Unfortunately, those businesses trade on the market and are indeed temporarily impacted by the market's volatility.  That's the risk part of risk/reward but rewards are what patient investors will enjoy.

As we approach Hallowe'en, I thought I would leave you with a couple of devilishly interesting numbers.  The March 9, 2009 bottom of the S&P 500 index was 666 and this year's low on August 25, 2015 on the Dow Jones Industrial Index was 15,666.  Just sayin'.