# THE LATO LETTER – WINTER 2015

North American equity markets diverged during the fourth quarter as US markets benefited from lower energy to end the year at all-time highs while the energy dominated Canadian market continued its decline in the quarter. The decline of Canadian equities was partially offset by the impact of a falling Canadian dollar boosting the value of the US holdings in your portfolio. The end result was an equity return for 2014 that was above the long term average return for equities.

The three years since the inception of Padlock have all been above average years for equities, particularly 2013, thus begging the question of whether or not investors can expect above average returns to continue.

A recent study of rolling five year returns on the S&P 500 Index done by Wharton School finance professor, Jeremy Siegel (a frequent CNBC contributor), suggests that although the past five years have been above average there are still strong reasons why above average returns can be expected to continue. In the study Siegel is quoted as saying “Although the returns in the last five years have been extraordinary, these returns came on the heels of the deepest bear market in 75 years that resulted in stocks trading at extremely undervalued levels.”

Siegel’s continued favourable outlook is partially based on the sub-par rolling 10 year and 15 year returns that resulted from the “lost decade” of negative returns between 2000 and 2009. Siegel’s study was featured in a recent issue of Barron’s and the table below shows some of the relevant statistics of rolling five year returns for the S&P 500 Index dating back to 1871.

**The Stock Market’s Positive Returns: 1871-2014**

Through holding periods of 15 years or greater, the stock market’s total returns, including reinvested dividends, have always been positive. For five- and 10-year intervals, there have been periods of loss, but these have been infrequent.

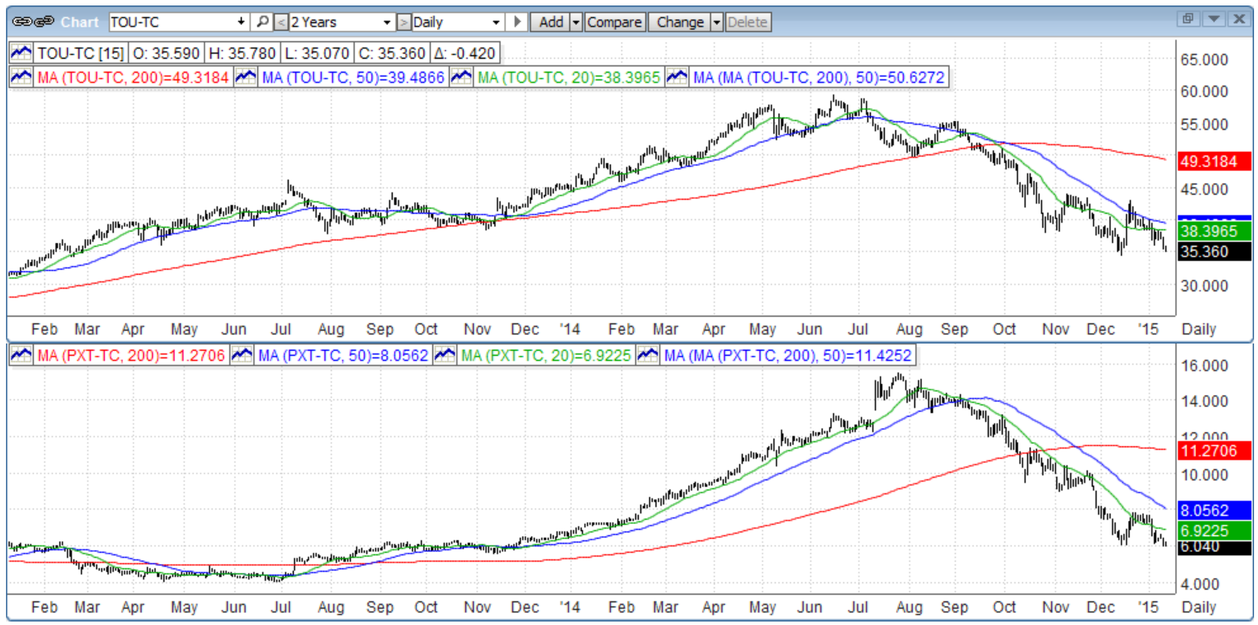
| | 5-year | 10-year | 15-Year | 20-year | 30-year |
|---|---|---|---|---|---|
| Stocks | 15.8% | 8.5% | 5.2% | 10.2% | 11.3% |
| **Updated Equity Data** | **5-year** | **10-year** | **15-year** | **20-year** | **30-year** |
| Best | 27.0% | 19.0% | 17.8% | 16.9% | 13.8% |
| 25th Percentile | 14.9 | 13.2 | 12.0 | 11.6 | 10.8 |
| Median | 9.5 | 8.6 | 8.4 | 8.2 | 9.6 |
| 75th Percentile | 3.3 | 5.4 | 6.1 | 6.7 | 6.9 |
| Worst | -15.6 | -2.1 | 0.2 | 2.8 | 4.1 |
| | **5-year** | **10-year** | **15-Year** | **20-year** | **30-year** |
| Number of times negative | 16 | 4 | 0 | 0 | 0 |
| Number of times total | 139 | 134 | 129 | 124 | 114 |

...edian, and 75th numbers are break points for the returns and not specific years.

Source: WisdomTree Asset Management

In previous commentaries and issues of The Lato Letter, I have discussed the damage done to investors’ psyches from the financial crisis coming on the heels of the bursting of the technology bubble earlier in the last decade. Those damaged psyches are a big part of why Padlock shares Siegel’s belief and remains constructive on the outlook for North American equities.

The dominant story of the fourth quarter was the steep fall in oil and gas prices, which has continued into the current quarter. There is no denying that Padlock, along with many other investment managers, did not anticipate the extent of the decline and the impact on the prices of the energy holdings in your portfolio. There are many theories, with perfect hindsight, as to why this has happened but behind all of the theories is the fact that oil and natural gas are commodities and commodities are governed by the laws of supply and demand.

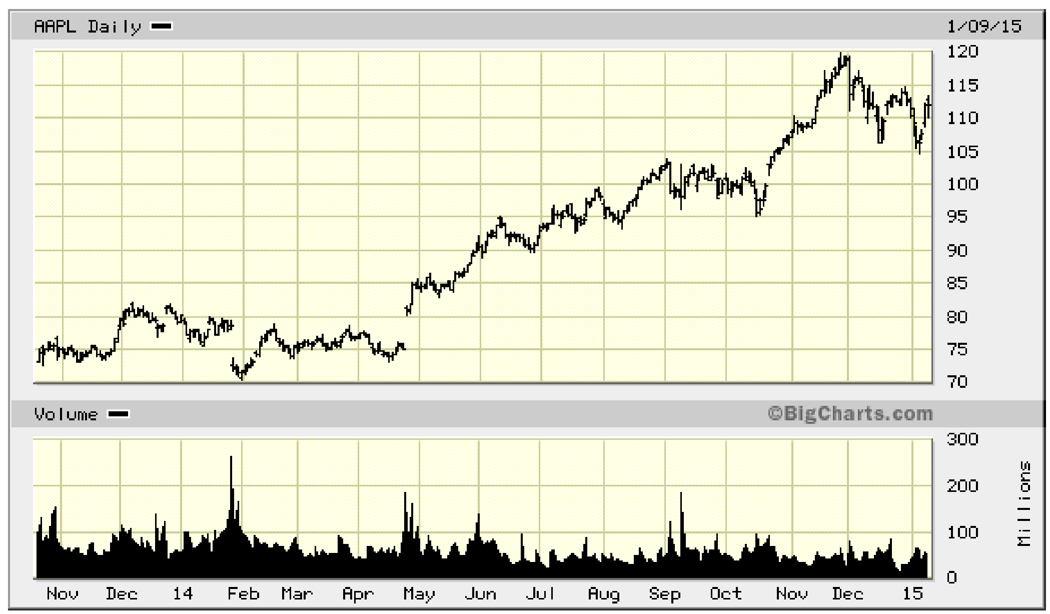



Energy commodities have historically been among the most volatile in their response to supply and demand and again with perfect hindsight, all of the new North American production that has been brought on stream in the last few years has tipped the supply/demand balance in favour of lower prices. In addition, the financial trading of energy futures contracts dwarfs the physical trading of the commodities and I believe that the increased financial trading has greatly exacerbated the volatility.

That combination of a supply/demand imbalance for now (it will change again as production slows and demand increases) and the increased volatility may drive prices even lower but I still remain confident that the energy companies in the Padlock portfolios are truly “best of breed” and will be survivors that reap the benefits of the next up cycle in energy prices. Of those holdings, the two that possess the brightest futures and biggest potential rebound remain Parex (PXT) and Tourmaline (TOU). See the December 11, 2014 issue of The Lato Letter for more information about these companies.

Not only was there a divergence between the US and Canadian equity markets in the last quarter, there was a bigger divergence between two of Padlock's US technology holdings throughout 2014. For many years, Padlock's large cap portfolios have maintained their US technology exposure through the two technology juggernauts: Apple(AAPL) and Google(GOOGL). After a disappointing 2013, Apple was a huge contributor to the positive returns in 2014 while Google took its turn to disappoint. The following charts show the performance of the two companies for the past 15 months.


It was difficult to totally comprehend Apple's miserable performance as a stock in 2013 and although Google has not faced as drastic a decline in percentage terms, its decline over the last is almost as puzzling. There have recently been reports of Google's declining market share of "search' queries on the internet as they fell 2.1% in December to 75.2%. Any business that has 75% market share of any market is a great business and in keeping with Padlock's philosophy of owning great businesses at good prices, Google's current valuation presents a great opportunity.




The analyst community is expecting Google to continue to grow its earnings at a rate of 17% per year and the stock at the time of writing is trading at 16.5 times next year's consensus earnings estimate. As is also the case with Apple, Google carries a huge cash position equivalent to about $90.00 per share and on an ex-cash basis is trading at approximately 13.5 times next year's earnings. The ability to own an incredibly strong business that is still estimated to be able to grow in the high teen's at a multiple of earnings below the growth rate is extremely compelling and the reason that Google remains the second largest weighting in the large cap portfolios.

At its current price, Apple is also deserving of its status as the largest weighting. After a strong year with a 40% total return in 2014, Apple is still valued at less than 13.0 times next year's earnings and that is before backing out the $20 of cash per share. Apple has become far more "shareholder friendly" recently by initiating and increasing its dividend and share repurchases.

The lacklustre performance of Google over the past year can be partially attributed to the fact that it "missed" the past three quarterly earnings estimates. Google has always been a company that does not focus excessively on its quarter to quarter results and it paid the price by falling out of favour with investors. An adoption of a more shareholder friendly attitude by initiating a dividend and/or share repurchase program, something that is entirely possible, could serve as a catalyst to enhancing Google's valuation.

In summary, Padlock remains constructive in its outlook for equity markets for the next year; acknowledges the current difficulties in the energy area while remaining convinced that the energy companies held in its portfolios are among the best in breed, will survive the current decline and once again prosper; and that the large cap exposure to technology through Apple and Google will continue to be rewarding in the years ahead.