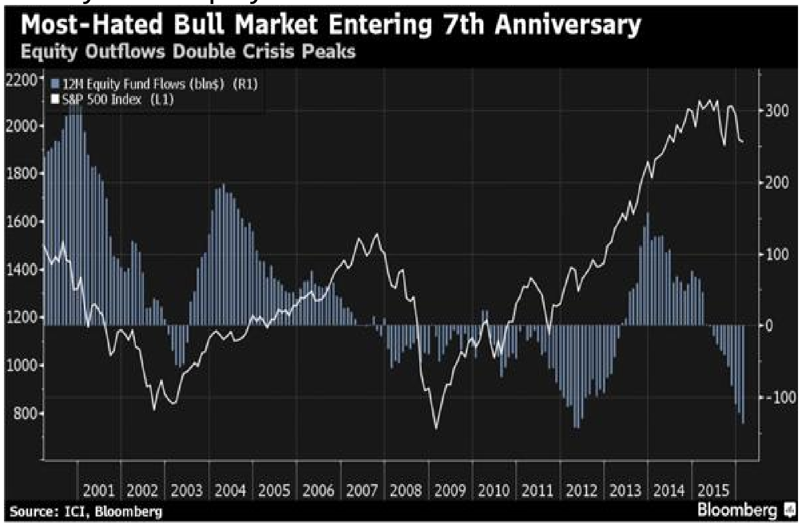
# The Lato Letter Spring 2016

In last quarter's commentary, I wrote about the notion that 2015 was the most confusing year that I and many other investment professionals had experienced in their careers. On the surface, the first quarter of 2016 did very little to alleviate that confusion. Markets appeared to be disconnected from the fundamentals in the first six weeks of the quarter and very sharp declines ensued before an equally sharp recovery in the last weeks of the quarter brought equity markets essentially back to or slightly ahead of the year end levels. Fortunately, the capital in your portfolio was preserved with a positive return that was slightly ahead of an essentially flat benchmark.

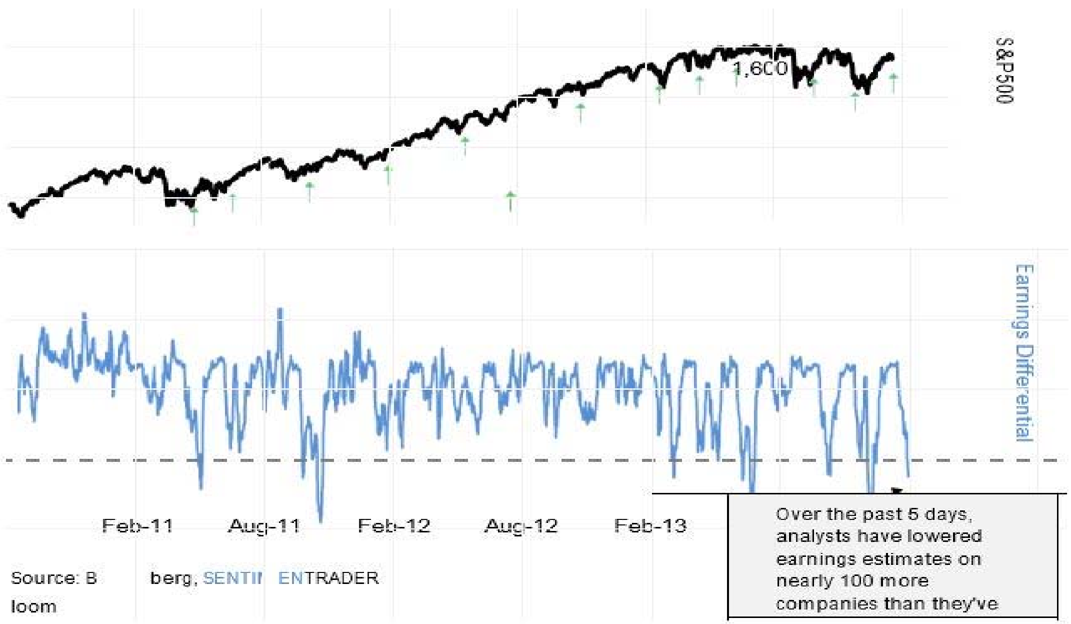
Stepping back with detachment from the "fear" of those first six weeks, it would appear that this disconnect from the fundamentals was largely driven by those investors with exaggerated exposure to energy commodities and in particular the Sovereign Wealth Funds (SWF) of energy intensive countries. As the year began, energy prices continued their decline from the 2014 peaks. When it appeared that "no bottom was in sight" (and it always does before a bottom is reached), it would seem to make sense that with prospects of lower revenues from energy in 2016 and cash flow needed to fund their commitments, the SWFs maybe have sold what they could and that was stocks. After many years of being net buyers of stocks with the excess cash flow from their energy revenues, they may have temporarily turned into net sellers. Rather than the decline in commodity prices and the equity markets signaling an imminent global recession, it was more likely that it was simply that the supply of stocks overwhelmed the demand for stocks for a few weeks. After all, in the words of the Nobel prize winning economist, Paul Samuelson, over 50 years ago "the stock market has predicted nine of the last recessions".

Padlock remains constructive on the equity markets and a large part of that constructive stance stems from the continued lack of optimism that persists among investors and the investment community. A recent publication noted that famed fund manager Louis Navellier described the current equity market as the "Most-Hated Bull Market Ever". His description was based on the flow of funds into and out of equities since the financial crisis. As the chart shows, other than the period from late 2013 to late 2014, investors have continued to withdraw money from equity funds and those withdrawals have intensified in recent weeks. According to data (stretching back to 1984) compiled by Bloomberg and the Investment Company Institute, "in the 12 instances when funds experienced monthly outflows that were at least two standard deviations from the historic mean(as they are now), the S&P 500 rose an average 7.1% six months later, compared with a normal return of 3.9%." With outflows nearing their highest level in the last 15 years, that pessimism bodes well for equities for the balance of the year.



Not only are investors generally pessimistic, so too are the equity analysts on Wall St. The chart below dating back to 2010, courtesy of Sentiment Trader, shows the weekly net of upward earning estimate revisions compared to downward revisions. As you can see, most previous times when the downward revisions outnumbered the upward revisions by 100 or more (the dotted line), the direction of the market was clearly positive.

**Figure 1: S&P 500 companies with raised minus lowered earnings estimates by Wall Street analysts (5-day average)**



Although the previous discussion has centred around the overall direction of the equity market, what ultimately determines a portfolio's return is the performance of the companies held in the portfolio. If this market is the Most-Hated Bull Market Ever, then perhaps, it might be that a long time holding, in fact the biggest holding in most portfolios, is the Most-Under Appreciated Stock Ever. As you have probably surmised that stock is Apple (AAPL-Nasdaq, $108.99). Before being accused of being a perma-bull on Apple and always touting it, I would like to point out that the last time Apple was recommended in a quarterly commentary was over 2 years ago in the fourth quarter commentary of 2013. The chart to the right (charts courtesy of Market Q) is Apple's two year chart then and the chart below is Apple's three year chart now.



Entering 2014 Apple had gone through a period where it had been decried for a lack of innovation and its price/earnings multiple based on trailing 12 month earnings at the time was a very low 13.2 X. The same concerns are being echoed today as sales and earnings have flattened out over the past year on the heels of a modest upgrade cycle with the release of the iPhone 6 S. The price earnings multiple has drifted even lower to a miniscule 11.5 X trailing 12 month earnings. That multiple does not factor in the over $29 per share of net cash on Apple's balance sheet.

Even if one assumes little or very low growth ahead that multiple is very difficult to justify if you compare Apple to other technology stocks or other consumer stocks.  Based on their March 31, 2016 prices here are the current trailing 12 month for some of those stocks:

Alphabet (GOOGL-Nasdaq,$762.90) – 33.4X

Facebook (FB-Nasdaq,$114.10) – 88.4X

Microsoft (MFST-Nasdaq,$55.23) – 39.5X

Netflix (NFLX-Nasdaq,$102.23) – 365.1X

Coca Cola (KO-NYSE,$46.39) – 27.4X

General Mills (GIS-NYSE) – 25.8X

Nike (NKE-NYSE) – 28.5X

Starbucks (SBUX-Nasdaq,$59.70) – 36.6X

Apple’s future earning’s stream is clearly being valued at less than its peers.  Unless Apple’s future earnings stream is very disappointing, that valuation should improve and that improvement could happen soon.  In interim, you can collect a 1.9% yield with a dividend that will most probably increase when Apple reports its earnings later in April.

One of the stocks that hurt the performance during the quarter was Performance Sports Group (PSG-TSX, $4.15).  After battling currency headwinds for the last year (falling CDN$), as you can see in the chart below PSG started what appeared to be a modest but strengthening recovery until the company announced on March 8th that it would encounter a significant loss in the yet to released 4th quarter results.  Currency continued to play a part but the bankruptcy of one of its biggest customers, The Sports Authority, also weighed heavily on the results


The stock fell 66.1% that DAY and was trading as if investors expected it to be a bankruptcy candidate. After ascertaining that the company was not in danger of breaching its debt covenants in the near future and was in fact anticipating paying down a large portion of its outstanding debt by the end of the calendar year, the holding was increased dramatically the following day. The company remains the leader in its various product categories and actions have been taken by the company to restore profitability. Padlock remains confident that PSG will return to profitability and that the company will once again be a positive contributor to the portfolio as that occurs.

On a personal note, during the quarter there was also an addition to the Lato family when our daughter Mary Beth and her husband Joel welcomed Madeleine Alice on March 8th. Maddy or MA (I haven't decided which yet) was born in New York City and weighed in at 6lbs, 7oz. Everyone is very well

Although anticipating a continuation of volatility that we have endured so far this year, enjoy the spring that has finally brought some warmer weather, baseball season (in spite of the Jays slow start) and better markets ahead.