BNN BUSINESS NEWS NETWORK

Market Call Newsletter: January 24, 2017

Don Lato's Top Picks: January 24, 2017

BNN.ca Staff

Don Lato, president of Padlock Investment Management

Focus: North American equities

MARKET OUTLOOK

Equity markets have enjoyed the benefits of upward multiple revisions over the last few years and can no longer be considered “cheap.” That being said, Padlock remains constructive on equities, particularly those companies than can deliver strong earnings growth over this year and next.

There is obviously great uncertainty in the early days of the Trump presidency and markets generally don’t like uncertainty, so stock selection and portfolio construction become very important. Investors should probably expect a volatile year and the risk/reward of equities versus bonds in a low, but a rising rate environment still favours equity exposure in line with an investor’s long-term objectives.

TOP PICKS

PAREX RESOURCES (PXT.TO) – Last purchase last week at $15.71
Parex has a number of ongoing exploration plays in Colombia that have yet to reach their full potential. The company will have an active exploration and development program in the first half of 2017 that will be entirely funded from their current cash flow.

From just over 10,000 boe*/day of production in 2012, Parex is guiding production to be just under 30,000 boe/day in 2017 with further growth to 35,000 boe/day next year. At those levels of production, cash flow estimates grow from $1.23 per share in 2016 to $2.37 per share for 2017. With a debt-free balance sheet, exploration potential that could exceed their own guidance and cash flow multiples below their peer group, even after a 66 per cent return, Parex can still be a big contributor to the returns of the small-cap portfolio.

*Barrels of oil equivalent

BORGWARNER INC. (BWA.N) – Latest purchase in early November at $35.80
BorgWarner is a key supplier to the auto industry in meeting their goals of achieving more stringent emission and fuel economy standards. Investor worries over the company’s

exposure to combustion engines have held the stock back over the last couple of years in spite of the fact that BWA is also exposed to hybrid and electric vehicles. Those worries may be overdone since BWA's non-combustion exposure is growing and the stock is trading at multiples well below its historical average.

The stock is trading at just over 11 times fiscal 2017 earnings, which is well below the company's five-year average multiple of 14 times earnings. Analysts continue to be cautious and their estimates continue to be below the company's guidance. The stock has performed well since being added to the portfolio in October, but the low valuation due to the lowered and potentially misguided expectations continues to provide an excellent entry point for the stock.

WINNEBAGO INDUSTRIES INC. **(WGO.N)** – Latest purchase early January at $33.00
Winnebago is an American icon synonymous with motorhomes. The company has been the top-selling motorhome brand every year since 1974. The RV lifestyle continues to remain popular with consumers and the prime target age audience continues to grow as more and more baby boomers enter retirement age. Winnebago management successfully managed the company through the recession and has a healthy balance sheet and no debt.

The stock is trading at price/earnings (P/E) multiple of 13.5 times August 2017 earnings and just 11.5 times August 2018 earnings with an estimated year-over-year growth rate of 18 per cent. Winnebago has recently completed the acquisition of Grand Design Inc., one of the leading players in the luxury towable RV market. The addition of its product line, combined with incorporating the manufacturing "best practices" of Grand Design, should help to propel the company in achieving those estimated earnings targets. In spite of the fourth-quarter rise in the stock price, the current level offers a great entry point for long-term growth.

DISCLOSURE	PERSONAL	FAMILY	PORTFOLIO/FUND
PXT	Y	Y	Y
BWA	N	N	Y
WGO	Y	Y	Y

PAST PICKS: JANUARY 27, 2016

APPLE (AAPL.O)

- Then: $93.42
- Now: $120.03
- Return: +28.48%
- TR: +31.34%

AECON GROUP (ARE.TO)

- Then: $13.63
- Now: $15.72
- Return: +15.33%
- TR: +18.60%

PAREX RESOURCES (PXT.TO)

- Then: $9.23
- Now: $15.23
- Return: +65.00%
- TR: +65.00%

TOTAL RETURN AVERAGE: +38.31%

DISCLOSURE	PERSONAL	FAMILY	PORTFOLIO/FUND
AAPL	Y	Y	Y
ARE	Y	Y	Y
PXT	Y	Y	Y

PERFORMANCE SPORTS GROUP (PSGLQ.PK)
Performance Sports Group was one of my Top Picks in April of last year. I sold the stock in December at US$1.70.

FUND PROFILE: PADLOCK GROWTH COMPOSITE

The Padlock Growth Composite is the amalgamated return for all clients under Padlock's management for the full calendar year in 2016 that are in a mandate of 100 per cent equities with the benchmark noted below. There are 15 clients and a total of $22.2 million in the accounts. The exact weightings of the accounts are not 100 per cent identical but based off a model whose weights are shown below. The returns are actual client returns, not model returns.

Here are the numbers for the Padlock Growth Composite compared to its benchmark, which is 50 per cent of the S&P/TSX Total Return Index and 50 per cent of the S&P 500 Total Return Index in Canadian dollars. Figures are to December 31, 2016.

- 1 month: Padlock 1.8%, Benchmark 1.8%
- 1 year: Padlock 20.2%, Benchmark 14.8%
- 3 years: Padlock 15.2%, Benchmark 12.1%

Padlock's returns are total returns net of fees.

TOP HOLDINGS AND WEIGHTINGS

1. Apple: 7.1%
2. Alphabet A & C: 6.8%
3. Parex Resources: 6.5%
4. New Flyer Industries: 4.6%
5. Visa: 4.5%

TWITTER: @donlato
WEBSITE: www.padlockinvestment.com

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Jason Del Vicario's Top Picks: January 24, 2017

BNN.ca Staff

Jason Del Vicario, portfolio manager at HollisWealth

Focus: North American growth stocks

MARKET OUTLOOK

The North American indices are for the most part trading near all-time highs on post-Trump-election-win optimism. Interestingly, the financial markets hate uncertainty and it could be argued that the economic picture is as uncertain as it's been in quite some time, yet the stock and bond markets are suggesting "all systems go." We've seen rates back up materially after the election and we believe this bears monitoring closely. As an example, the 30-year Treasury yield has moved from 2.18 per cent to 3.06 per cent fairly rapidly. While the move has been swift and sharp, it has done this many times since the beginning of the "great bond bull market" in 1982. We will also note that the long-term downward trend, while in jeopardy, has yet to be broken. We fail to see how Trump being elected will affect the structural factors that have led to interest rates plummeting to new lows. These include, but aren't limited to, demographic shifts and massive government, corporate and personal debt levels impeding growth. It could be argued that tearing up trade agreements and imposing tariffs on foreign goods and services won't be good for global GDP growth, which would lead to rates dropping anew. We would be remiss to fail to point out that we haven't had a recession in eight years; we are due and, again, this will likely lead to rates falling. In short, we will take our cue from the markets in terms of asset allocation, but we feel this is an example of an area where investors and the markets may be misreading the data.

We also note that the types of companies we own and follow, which can generally be classified as growth/high ROE companies, have trailed the market indices of late. One can almost see the money flowing from these types of companies to financials and energy; the complete opposite flow of funds was seen as recently as 2015 and, to a lesser extent, the summer and early fall of 2016. The financial and energy sectors contain few stocks that meet our strict selection criteria. It's worth noting that we are more comfortable predicting that Dollarama will open more stores in 2017 and increase their same store sales growth than where oil or interest rates are headed. At times like this, it is critical to understand one's investment strategy and objectives. We seek to own shares in companies that have demonstrated a pattern and history of increasing shareholder value and earnings. We do this by screening for stocks that can demonstrate long periods of above-average earnings growth and ROE generation. While most stocks don't drop through our filter, those that do generally have some element of economic moat or competitive advantage around their operations. We then think about the source of these advantages and whether their economic moat is widening or narrowing and how long this advantage is likely to last. In this context, general market direction and even general economic direction matter less than the performance of the individual companies we own and follow. In short, buy good-quality companies at attractive prices, and the rest tends to take care of itself.

In short, at this juncture we can offer very little insight as to what will happen in the next few months. Uncertainty in terms of economic policy and direction is high and predictions are generally wrong at the best of times, so we will politely pass on bold predictions. We however do feel comfortable owning high-quality companies that possess some form of economic moat enabling them to earn outsized profits for shareholders. We feel that now more than ever, owning quality companies will generate alpha for investors, especially given the recent period of underperformance of these types of companies.

TOP PICKS

MARKET VECTORS ETF TRUST (MOAT.US)

When recently conducting research on the concept of "economic moats" and "competitive advantages," I came across the Morningstar Wide Moat Focus (MWMF) index. This is a clever index that provides exposure to companies in the Morningstar US Market Index with U.S. economic moat ratings of wide that are trading at the lowest current market price to fair value ratios. This is very similar to the concept put forth by Joel Greenblatt's excellent book, 'The Little Book that Beats the Market.' While the assignment of a "moat rating" for a given company is subjective, the process is very similar to how we think about and screen for stocks — namely, looking for companies that have a high level of ROIC in relation to their WACC and have been able to sustain these margins for extended periods of time. I then found an ETF that seeks to replicate this index in the form of MOAT. The MWMF index has done very well in relation to the S&P 500, and I will now certainly watch this with interest and may add. I also note that Vaneck (ETF issuer) also has an ex-U.S. version of this ETF, again based on an underlying Morningstar index.

MASTERCARD (MA.N)

Speaking of economic moats, we've owned MasterCard since inception (September 2014) and feel that they, along with other credit card companies, have large sustainable competitive advantages that have enabled them to earn outsized profits for long periods of time. What is perhaps not well understood is that MasterCard doesn't actually have any credit risk. This is to say that if someone doesn't pay their bill and defaults, MasterCard isn't on the hook, but rather the issuer (most often a bank) is. Of course, this can hurt them too because when cardholders perennially carry a balance on their card, the very high interest payments (profit) is paid to the issuer. MasterCard, rather, makes money every time the card is used; as long as use of cards increases over time, MasterCard will continue to benefit. We may feel that we've reached credit/debit card saturation in Canada, and to some extent that is accurate. However, credit card and debit card use in places like southern Europe, Asia, Africa and South America is nowhere near as prevalent, and therefore represents longer runways of growth. We therefore feel that MasterCard will continue to grow their earnings for many years to come. For completeness sake, we would also recommend Visa and to a lesser extent American Express.

PACIFIC INSIGHT ELECTRONICS (PIH.TO)

Each appearance, I try to highlight a company that is small yet meets our selection criteria. Pacific Insight designs, develops, manufactures and delivers solutions to the automotive and commercial vehicle markets. Their main products are LED lighting systems. Their clients are well known and include Ford, Tesla and Caterpillar, to name a few. PIH doesn't have the high ROE history that we like to see, but their cash ROE is above our minimum threshold and trending higher. While we haven't done a lot of research into the demand profile for their products, we do note that their revenues have jumped twice recently, in 2013 and 2015 to present. Their last quarter was weak due to some one-time costs associated with a product launch, and the stock sold off sharply from nearly $15 down to $7 and looks to have stabilized around $9. They are also very reasonably priced trading at 7.5 times trailing earnings. This obviously shouldn't be a large percentage of one's portfolio, but we think that if they can get back to the financial performance of 2016 (they've given every indication this will happen) then we like the risk/reward relationship at these levels.

DISCLOSURE	PERSONAL	FAMILY	PORTFOLIO/FUND
MOAT	N	N	N
MA	N	Y	Y
PIH	Y	Y	N

PAST PICKS: JULY 4, 2016

BIOSYENT (RX.V)
We continue to own and like Biosyent. Of note: the share price has sold down to the low $7s, which we would suggest is an excellent level to initiate or add to one's position. This remains a very stable and well-run company. This is more of a "get rich slowly" proposition than "get rich quickly," and that suits us fine. We look forward to seeing the launch of the two cardio products. These have the prospect of increasing RX's top line by 60 per cent once operating at conservative peak sales levels.

- Then: $8.20
- Now: $7.30
- Return: -10.97%
- TR: -10.97%

CEAPRO (CZO.V)
We continue to own and like Ceapro. We note that it's been featured recently by other BNN guests, so it's nice to see others taking notice. They recently opened a new production facility, and the stock has been quite volatile. There seems to be excellent support at $1.20 with resistance at $2. If you can buy closer to $1.20, we feel this represents excellent value. We note their last quarter was a bit soft on the revenue side, and we suspect this is due to the inevitable growing pains of launching a new facility and processes.

- Then: $1.53
- Now: $1.74
- Return: +13.72%
- TR: +13.72%

DOLLARAMA (DOL.TO)
We continue to own Dollarama. We are overweight the position (approximately five-per-cent weight). They've spent the better part of six months trading sideways, but knocking it out of the park operationally. We find these types of stocks (ATDb, CSU, DOL, CCLb, GIBa, etc…) will put in most of their gains in a relatively short period of time. That is to say we will see growth stocks consolidate over months, yet jump (or drop — it does happen!) over weeks. This is a long-term hold for us and we have no doubt the stock price will perk up as the earnings play catch-up to prior large moves in the stock.

- Then: $90.95
- Now: $100.35
- Return: +10.33%
- TR: +10.67%

TOTAL RETURN AVERAGE: +4.47%

DISCLOSURE	PERSONAL	FAMILY	PORTFOLIO/FUND
RX	Y	Y	Y
CZO	Y	Y	Y
DOL	N	N	Y

FUND PROFILE: JDV MODERATE GROWTH PROFILE

PERFORMANCE AS OF DECEMBER 31, 2016:

- 1 month: Fund -0.40%, Index* +1.41%
- 1 year: Fund +4.21%, Index* +24.30%
- Since inception (September 2014, absolute): Fund +24.30%, Index* -2.80%
- Since inception (September 2014, compounded): Fund +9.80%, Index* -1.17%

* Index: Composite Benchmark: 30% TSX, 35% Universe Bond, 20% S&P Pref, 15% TSX Small Cap
* Based on re-invested dividends. Returns are net of 1.5% management fees.

TOP HOLDINGS AND WEIGHTINGS

1. RP Strategic Income Fund (RPD110): 9.48%
2. Constellation Software Debenture (CSU.db): 9.42%
3. Alimentation Couche-Tard (ATDb): 5.63%
4. Constellation Software (CSU): 5.40%
5. Facebook (FB): 5.10%

TWITTER: @jasondelvicario
WEBSITE: www.hillsidewealth.ca

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