The Lato Letter Winter 2017

What a year! 2016 started with free falling energy prices and equity markets having their worst month since August 2011. Energy prices and markets then stabilized and rallied back to even for the year before the surprising Brexit vote. The Brexit results led to in a one day plunge before markets again stabilized and then rallied strongly during the normally low return summer months. As if that wasn't enough, November brought the even more surprising U.S. presidential victory by Donald Trump which most expected to be a death knell for markets. Those expectations were met for about six hours as equity futures plunged dramatically as the election returns came in before reversing prior to the market opening thus marking the beginning of the "Trump Rally".   In the weeks following the election, although the uncertainty of a Trump presidency remains, the major indices in the US all reached new all-time highs while the S&P/TSX index rebounded to within about 1.5% of its September 2014 all-time high. Somewhat surprisingly as well, the CDN$, although very volatile, ended the year slightly ahead of last year.

S&P 500

S&P/TSX

C$/US$

At the end of the day, as you can see from the charts above, it was a good year for investors and an even better year for Padlock's clients as the Padlock Growth and Balanced Composites once again outperformed their respective benchmarks.

If we can learn anything from last year, it is that the value of forecasting what the return will be for equity markets over a short period of time is very low. Obviously, one must be cognizant of past performance of the market under various conditions, the current business and economic backdrop, valuation levels and many other factors in building a portfolio. What is more important though is building a diversified portfolio of well managed companies that are trading at reasonable valuations and offer prospects of rising earnings that can translate into higher dividends and stock prices. That is the approach that Padlock takes.

Therefore, when I am asked what my forecast for the equity market is for this year (and every year), my answer is that investors should target the long term historical total return for equities of 8% to 10%. Very few years will fall into that range and in fact in the five year history of Padlock the pure equity benchmark has not once has the annual benchmark return been in that range. The benchmark return has varied from 5.59% to 26.60% with a compound annual return of 14.72%; a very favourable period that is well above the historical return expected. During that period the Padlock Growth Composite (a measure of the combined returns of those Padlock clients whose mandate is 100% equities) has enjoyed a compound annual return before fees of 20.11%. The Padlock Balanced Composite (a weighted measure of the combined returns of those Padlock clients who have a balanced mandate) has a five year return of 12.06% before fees compared to its benchmark of 7.13%.

The standard disclaimer which states, “Past performance is not indicative of future performance” must be noted but the approach employed by Padlock will be consistent with the approach described a couple of paragraphs ago. In keeping with that approach, BorgWarner Inc. (BWA-NYSE; $39.44US) was added to the Padlock equity portfolios during the last quarter.

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.

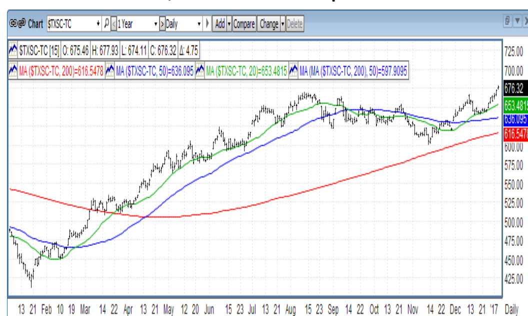
The stock is trading at just over 11 times fiscal 2017 earnings which is well below the company’s five year average multiple of 14 times earnings. Analysts continue to be cautious and their estimates continue to be below the company’s guidance. The stock has performed well since being added to the portfolio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

One of the main contributors to the Canadian side of the portfolio in the last year and particularly in the last quarter is anything but a recent addition. Toronto Dominion Bank (TD-TSX, $66.22CD) has been an anchor of the Canadian equity portfolio for many years. The bank continues to be very well managed, trades at a reasonable valuation and has earnings growth opportunities ahead of it.

TD cannot be described as a "table pounding buy" at current levels. The earnings multiple is just over 12 times October 2017 earnings which is in-line with its average multiple over the last five years. The bank has ably navigated some of the issues facing the Canadian banks and is well positioned in the US market to capitalize on what may be a more favourable operating environment. After a 9.4% post-election increase, the stock cannot be expected to continue that type of performance throughout 2017 but it continues to deserve a place in the portfolio. With a 3.3% dividend yield, the stock can be comfortably held as the earnings catch up to the current price and the opportunity for above average returns for the stock materialize.

Padlock's Small Cap Composite(a measure of the combined returns of those Padlock clients whose mandate is 100% small cap equities) also enjoyed a strong year as the Small Cap Indices actually outperformed their Large Cap bretheren. The composite slightly lagged the benchmark for the year but maintained its superior performance on a five year basis.

S&P/TSX Small Cap



Russell 2000

Comparing it to the composites mentioned above, the small cap benchmark return has varied from -0.02% to 29.06% with a compound annual return of 13.24%. During that period the Padlock Small Cap Composite has enjoyed a compound annual return before fees of 13.93%.

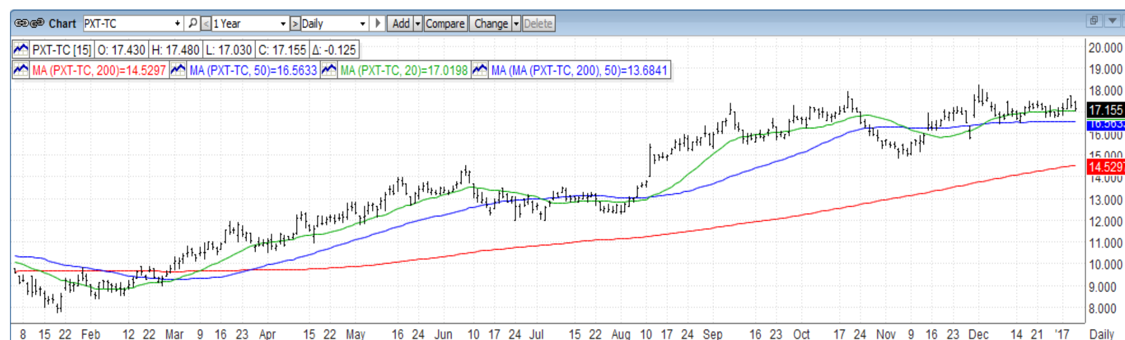
Under the constant objective of always improving the portfolios, Winnebago Inustries Inc. (WGO,NYSE, $31.65US) was added to the Padlock small cap portfolios just after the end of the quarter.

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%. Winnebago has recently completed the acquisition of Grand Desgin 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.

One of the biggest contributors to strong return of the small cap portfolio in 2016 has been a long time holding. Parex Resources Inc. (PXT-TSX, $16.90), which had an excellent year on the exploration front, enjoyed a 66% return for the year. Final production numbers and reserve additions will be known on February 6th when the company releases its independent reserve report; possibly providing a boost for the stock.

Parex has a number of ongoing exploration plays in Columbia 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 2016 with further growth to 35,000 boe/day next year. At those levels of production, cash flow estimates grow from $1.23 CDN per share in 2016 to $2.37 CDN 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% return, Parex can still be a big contributor to the returns of the small cap portfolio. *(barrels of oil equivalent)

On a personal note, our son Matt's wife Isabel, delivered our third grandchild last week. Frederick Donald Michel Lato was born on January 18th at a robust 7lbs and 13 ounces. Everyone is doing well.

As I write this commentary, the Dow Jones Industrial Index continues to flirt with the 20,000 level, we have witnessed the first couple of days of the Trump presidency and after a bit of a cold snap temperatures are unseasonably warm. How all of this plays out to the equity market returns for 2017 is noise at this time but I am very comfortable that the holdings in the portfolio (although always looking to improve them) are strong, well-managed companies, trading at fair or cheap valuations that provide you the opportunity for superior returns over the medium to long term.

This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change without notice.

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