Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | OCTOBER 2, 2013

With U.S. markets soaring to new highs in the third quarter, the financial crisis of 2008 seems like a distant memory. The third quarter turned out to be surprisingly positive with both the U.S. and Canadian markets up 4-5%, on average. Meanwhile, market "bears" who have missed out on rising share prices in 2013 continue to mope, slamming Big Ben for distorting market valuations and sending unclear messages. So when the Fed chairman announced in early September that the stimulus must go on and that any "tapering" would be delayed until 2014, share prices shot up even more.

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Independent & Objective

Keep The Stimulus Party Going

It seems the financial stimulus party that everybody thought was scheduled to end at midnight has been pushed forward into the wee hours of the morning.

Now, nobody enjoys a good all-night party more than I do, but I have to wonder what scared Bernanke from not easing the "quantitative easing." Accordingly, the American economy seems to be emerging strongly from the deep recession of recent years.

Auto sales are on a roll. And unlike six years ago, when car companies were at or near bankruptcy in spite of record sales, the auto industry is once again a lucrative place to do business. Both GM and Ford shares outperformed in 2012, and are up 27% and 30% respectively year-to-date in 2013.

The U.S. is also experiencing a recovery in construction, factory orders, and home sales — albeit in a scattered fashion. U.S. construction spending was at a four-year high in July. Manufacturing activity in August expanded at the fastest pace in two years. Finally, U.S. home prices rose 12.4% in July compared with a year ago. This is the biggest annual increase in seven years, as the number of Americans looking for homes continues to climb.

That said, Big Ben was probably concerned with three specific metrics.

Lies, Damn Lies, and then there's the US Unemployment Statistic

First, unemployment in the U.S. continues to be abysmal. Yes, the unemployment rate dropped to 7.6%, but for all the WRONG reasons. The rate dropped not because more people were employed, but because the labour force shrank as a result of people giving up on finding work!

Second, companies in the S&P 500 are showing little, if any, growth in their top line revenue numbers. Although corporate earnings are growing at an annualized rate of 4-6%, much of that growth results from debt refinancing and cost-cutting measures — not because sales are increasing.

When such companies as John Deere (the leading agricultural equipment manufacturer) can finance 10 years of new debt at an incredibly low interest rate of 1.7%, that certainly helps the bottom line. Unfortunately, there is a limit to how much costs can decrease. At some point, companies have to rely on sales growth to propel earnings.

Third, inflation is almost nonexistent in the U.S. — this fact has Bernanke on high alert. To a certain extent, inflation in moderation is actually good for the economy. Make no mistake: hyperinflation is bad; zero inflation is worrisome; and deflation is outright scary, as it can shut down consumer spending and lead to economic downturn to occur. With inflation hovering at about 1%, the U.S. is operating in the 'worrisome' low inflation spectrum.

With the Fed judging the economy to still be vulnerable, investors can breathe a sigh of relief that rates will not begin to surge. Not only did the S&P 500 rally to a record high in response to the move, but the yield on the 10-year Treasury note fell to its lowest level in more than a month.

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With more money flowing into equities, are the markets starting to look overbought?

Given the prospect of low rates together with parts of a strengthening economy, we believe that equity investments have become more attractive relative to bonds. In all likelihood, we expect to see even more fixed income investors rotating out of bonds and into equities over the next several months. With more money flowing into equities, are the markets starting to look overbought?

The P/E Ratio

One of the key metrics for evaluating an overbought market is the price-to-earnings (or P/E) ratio. It is one of my favourite metrics because it is simple to understand, easy to calculate, and generally tells some kind of interesting story.

The P/E ratio became a popular stock value metric in the 1930s, championed by value investors Benjamin Graham and David Dodd. The ratio measures how much an investor is willing to pay for every dollar of earnings that the company generates. To calculate the ratio, one simply divides the prevailing share price by the company's earnings per share.

For example, Microsoft shares trade at approximately $33 per share. Last year, the company generated $2.58 in earnings per share. Therefore, the stock has a price-to-earnings ratio of 13 ($33 / $2.58). It implies that an investor is willing to pay $13 for every $1 of earnings that Microsoft generates. In finance lingo, we portfolio managers would say that Microsoft trades at "13 times earnings".

Facebook, on the other hand, has a whopping P/E ratio of 200 which means that an investor is willing to pay $200 for every $1 of earnings. Why is Facebook able to attract such a higher valuation than Microsoft?

The answer has to do with earnings expectations. Facebook

PUT OPTION STRATEGY: INSURANCE FOR A DOWN MARKET

GIVEN OUR EXPECTATION THAT VOLATILITY WILL INCREASE IN THE MONTH OF OCTOBER, WE STARTED BUYING PUT OPTIONS ON VARIOUS INDICES TOWARDS THE LAST WEEK IN SEPTEMBER.

Put options are a means to insure against increased market volatility and to 'protect the portfolio'. One buys them on a stock exchange in exactly the same manner as buying stocks. When the market drops, the puts increase in value — thus helping to offset investment losses in the portfolio.

While one advantage of puts is to provide downside protection, another advantage is that they enable investors to fully participate in an up market. Unfortunately, no investment advisor including myself has a crystal ball. While I may think there is a 70% chance that October will be a choppy month, I also believe there is a 30% chance that markets continue their upwards momentum. Put options allow us to better position the portfolios to handle both scenarios.

Whereas 'taking profits' calls for taking money out of the market and possibly realizing capital gains, puts enable investors to remain fully invested in the market without having to sell a single stock. Investors can remain 100% vested in the market while taking comfort knowing that a portion of the portfolio is hedged.

Surely, there must be a catch with options -- what's the catch? The drawback with puts is that it costs money to buy them and they expire after a certain time period. In this way, puts behave like a life insurance product. Investors select how much coverage they want for their investment portfolio, and for what time period.

Strategically, we manage the cost of the puts. At Frontwater, we never hedge 100% of the portfolio with puts as that would be too costly. Depending on our client's stated risk tolerance objectives, we often seek to hedge 10-40% of a portfolio at opportunistic times. Generally, we look to add put protection when investor confidence is high and market volatility is low. It is at these times when the cost of the put (ie. the insurance) is lowest.

"...inflation in moderation is actually good for the economy."

is a juggernaut in the social media arena. It has hundreds of millions of users and is only starting to figure out how to monetize its relationship with its vast customer base. Last year, it generated 22 cents per share in earnings. This year, it is on pace to generate more than four times that amount — almost $1.00 in earnings per share is forecasted. If we now apply this year's forecasted earnings of $1.00, the forecasted P/E drops to around 50 times earnings ($50 / $1.00).

You can begin to see how companies that post strong earnings growth enjoy richer stock prices and fatter P/E ratios than those that don't. The P/E ratio comes down quickly for companies able to generate earnings at an accelerated rate. Today's Facebook investors are willing to pay 200 times for Facebook's trailing earnings because they believe earnings can consistently grow at 25-30% per year for at least the next 4-5 years.

Microsoft operates in a mature industry and has a slower growth profile. Unlike Facebook, earnings at MSFT are xpected to grow at 5-7% per year. Accordingly, investors value the company at a much lower P/E multiple.

And for companies where the sustainability of earnings is in serious doubt, the P/E ratio can often be in low single digits. Companies with low P/E ratios tend to be ones in business turmoil either because of internal operational issues, or because the industry they operate in is dying, or both. Blackberry is a good example of a company that trades at a justifiably low multiple of 1.4.

Certain other factors, such as dividend yield, interest coverage, credit coverage, and so on, also play a role. Generally speaking, as value investors, we at Frontwater tend to screen for companies with earnings multiples in the 10-50 times range — sometimes higher, sometimes lower, but generally in that ballpark.

At current levels, we believe stocks and the market as a whole are fairly valued. Both the S&P500 and the Dow Jones Industrial average are trading slightly above their historical price-to-earnings average.

Trouble is, it appears that the US government is headed for its second fiscal cliff in less than 10 months. Failure to raise the $16.7 trillion debt ceiling by mid-October would force the U.S. to default on some payment obligations — an event that could cripple the economy and send shockwaves around the globe. As we saw in the winter 2012, it looks like both political parties (but more so the Republicans) are willing to engage in a game of chicken to get the outcome each wants. Fasten your seatbelts as October looks to be a bumpy ride.

AP PHOTO/DOUG KANTER

AP PHOTO/BEBETO MATTHEWS

JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He holds an MBA and Engineering Degree (with Honours) and is a member of the CFA Institute and the Professional Engineers Society. He has more than 15 years capital markets experience.

Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Exempt Market Dealer, and Commodity Trading Adviser.

HELPING YOU MEET YOUR FINANCIAL GOALS

HIGHLY PERSONALIZED SERVICE: Frontwater Capital brings a sophisticated, personalized approach to wealth management. We work with each client to determine an appropriate strategy based on individual goals, preferences, and circumstances. Every aspect of a client's financial life is considered, enabling us to become essential partners to our clients.

DISCIPLINED APPROACH: We believe that long term investment performance is achieved by taking a disciplined approach to wealth management:

- Identify goals and objectives
- Determine asset mix allocation
- Make investment selection
- Monitor investment portfolio

Clients' assets are allocated amongst various investment vehicles in accordance with their investment and risk objectives after consultation with our licensed portfolio manager.

HOLISTIC APPROACH: Our experience shows that when you structure your affairs with large financial institutions, many issues slip through the crack. Our holistic approach ensures that we tailor solutions to your specific financial needs, investment objectives, and risk tolerance levels. While preservation of wealth and growth of capital are common goals to all our clients, we recognize that each relationship is unique. Since our clients are our most important asset, we make every attempt to ensure that we are meeting their goals.

FRONTWATER SERVICES

We have the expertise to protect our investors from currency fluctuations on US dollar denominated assets. Our investors can invest in markets outside Canada without having to worry about volatile foreign exchange rates.

SERVICES

- Managing Investments
- Assessing your Risk and Investment Profile
- Designing your Asset Allocation
- Customizing a Financial Strategy
- Retirement and Tax Planning Considerations
- Structuring of Family Wealth
- Estate Planning
- Business Continuation Planning
- Protecting US$ Investments against

CURRENCY RISKS

- Hedging against Extreme Events

PRODUCTS

- Equities
- Bonds
- Income Trusts
- Initial Public Offerings (IPOs), new issues
- Derivatives (Calls, Puts, Futures)
- Commodities
- FX Trading
- Insurance
- Alternative Assets
- Structured Products
- Closed End Funds

ACCOUNT TYPES

- Cdn$ and US$ cash and margin accounts
- RRSPs, RESPs, RRIFs
- Tax Free Savings Accounts (TFSAs)
- Individual Pension Plans (IPPs)
- Locked-In Retirement Plans (LIRAs)
- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

THRIVING IN THE NEW ECONOMY

The investment challenges associated with a volatile global economy require a robust portfolio optimization and asset allocation model. We help take these complex concepts and make them accessible to individual investors while factoring taxable and tax deferred investments into the mix

CUSTOM TAILOR-MADE SOLUTIONS: We work with each client to determine disciplined strategy based on their goals, preferences and circumstances. We structure and execute complex transactions and/or enhance the tax effectiveness of a particular investment. You deserve a customized solution for managing your wealth that is specific to your needs — not a generic template.

RISK MANAGEMENT: During a bull market when every investment seems to be going up in value, risk is often overlooked. But risk shows up during a market downturn when the results can be truly devastating. More often than not, financial advisors push exactly the wrong fund at the wrong time — Internet-oriented funds at the height of the tech bubble, commodity funds at the height of the commodity bubble etc. Many investors have recently discovered, to their dismay, that their portfolios were far more aggressively invested than they realized.

ASSET ALLOCATION: For most investors, implementing a prudent asset allocation strategy and investing with a long term horizon are more likely means of investment success. We seek to maximize the total return of a balanced portfolio, putting emphasis on the asset mix and how asset classes perform against each other.

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