Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JULY 2, 2014

WRITTEN AND PRODUCED BY
FRONTWATER CAPITAL

"A good defense is the best offense."

Watching the undermanned Costa Ricans beat Greece, I was reminded that World Cup Soccer is a little like value investing with options: Protecting your goal is just as important as scoring.

When Warren Buffett bought Heinz for $23 billion last year, he bought a boring old tortoise, not a flash-in-the-pan hare. Heinz is the perfect stock for a value investor like Buffett because the downside risk is limited and well known.

Both Heinz and its products have been around for over 135 years. Ketchup is found in 97 percent of households and Heinz owns the lion's share of the market. It's hard to imagine any type of scenario short of discovering a health issue with the indulgence of tomatoes where ketchup sales might decline let alone grow at a slower pace than that of the world economy.

The upside, aka revenue growth, admittedly is a tad more difficult to predict. Who really knows where sales growth and innovation can come from? Some technological initiatives like the first upside-down squeeze bottle did quite well. Other initiatives like green ketchup, not so much.

Still, smart investors like Buffet know that boring companies such as Heinz Ketchup or Gillette Razors, always find new and interesting ways to reinvent themselves; be it in new products, packaging, or operational efficiency. And while the mighty ketchup engine pulls the company steadily along, "Heinz 57" has a host of products from soups to pickles to vinegar to baked beans.

"Even though put options expire worthless in a rising market, the investor benefits because equity exposure is maintained rather than moved to the sidelines."

At Frontwater, we think Warren is on to something. Buffett has "peace of mind" in owning a stock like Heinz, and we are constantly working toward that same "peace of mind" with our portfolio of albeit higher growth stocks.

The traditional portfolio manager faces a dilemma. If the manager wants to de-risk the portfolio, there is but one option: sell stock for cash. But with absolute safety comes absolutely no gain at all. Money on the sidelines earns nothing.

A better way to defend against a market correction and to bring "peace of mind" to one's portfolio without necessarily heading to the sidelines is to hedge one's portfolio with put options.

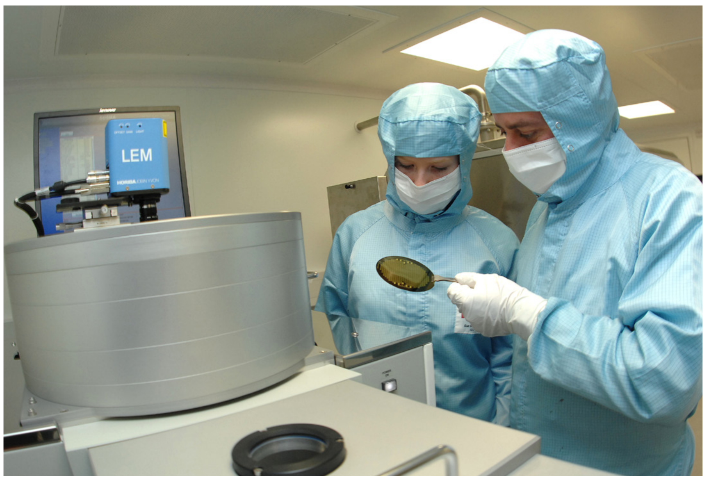
In a down market, the investor benefits because the put options increase in value which help to offset some (but not all) of the paper losses in the portfolio.

In an up market, the investor also benefits. Even though put options expire worthless in a rising market, the investor benefits because equity exposure is maintained rather than moved to the sidelines.

Only in a flat market does the investor get a little cranky for having unnecessarily spent a few dollars to protect the portfolio for seemingly no reason. Fortunately, because implied volatility is at an all-time low, the cost to buy put protection is also the cheapest it's ever been.

Successful World Cup teams all employ a strategy of fielding experienced and dependable players who can race ahead and put the ball in the net, but can also defend against a competitor's attack when they have a lead to protect. Investing in proven, veteran players like Heinz is one way to keep out of the tumultuous storm. Protecting your gains with put protection instead of pulling out of the game is another. FLT

TWO TECHNOLOGY COMPANIES WHOSE DEATHS WERE GREATLY EXAGGERATED



In today's world of hype, Hollywood, and "what have you done for me lately?" mentality, investors need to be careful about gravitating to the flashy upstarts of tomorrow over the solid "so last week" stars of yesterday.

APPLE (AAPL) $92.50 AS OF JUNE 30TH (PRE-STOCK SPLIT ADJUSTED PRICE: $647.50)
INTEL (INTC) $30.70 AS OF JUNE 30TH

Surprise! (AAPL) and Intel (INTC) are alive and well and doing just fine – and their reviving share prices this quarter are finally reflecting that reality.

Both companies had been unduly written off by many market enthusiasts despite having some of the strongest corporate balance sheets around, a reasonable Price Earnings ratio, and a generous dividend payout in the 3-4% range.

The knock on AAPL was that the days of hyper-growth status were long gone. Profit margins were beginning to erode, the company was losing market share to Samsung, there was little fanfare around new product releases, and the company would surely suffer under the CEO regime of Tim Cook.

Exactly one year ago, AAPL shares traded down to $400 having dropped more than 40% from the stock's all time high of $700.

Likewise, Intel had been puttering along with an 18-month average trading price of $22.50 before recently breaking out of its rut. The knock on Intel was that it was too "old-school" with approximately 70% of its revenue coming from the grey, established PC market, and thus highly sensitive to any adverse developments in the industry.

Perhaps it was saturation and high prices in the rest of the market that caused investors to take a second look at these bargain gems, as both of these companies saw their shares take off in the second quarter. Or maybe it was just something as old-fashioned as positive earnings announcements that caught their attention.

In any case, AAPL shares are up more than 25% for the quarter. INTC shares are up more than 20% since May 19th.

So, what did the skeptics have wrong?

For one thing, we now know that the market was overly pessimistic. Generally, companies with almost no growth will trade at a P/E of 9. And companies that are expected to go bankrupt within a couple of years will trade at an EBITDA multiple of 3. Yet, AAPL was trading at those exact levels not less than a year ago.

The market also underestimated each company's resiliency. Unlike Blackberry which was in denial and refused to adapt until the bitter end, both INTC and AAPL have an embedded corporate culture of quality, innovation and adaptation.

INTC spends $10 billion a year on R&D; Apple spends $4.5 billion. But because the market had grown accustom to these two companies hitting home runs in entire new product categories, lesser achievements went largely ignored. Many investors lost sight of the girth and depth that these companies were built on.

> *"It generally is better to buy a wonderful company at a fair price than a fair company at a wonderful price."*

Most recently INTC has been making inroads in the mobile computing market. In its last earnings announcement, Intel announced its intention in the second half of 2014 to release new mobile chips that focus on lower energy consumption and boost overall performance.

On the corporate front, Intel's server business is benefitting from the rise of the cloud, while the company continues to maintain its stranglehold dominance of the desktop and notebook PC computing markets with 85% market share.

In the case of AAPL, it has a whole slew of good news in its pipeline, even though there is no single category-killer to speak of. Loyal followers expect the iWatch to be launched in October of 2014. The iPhone 6 is also rumoured to be released sometime later this year. And thanks to two-year contracts offered by most networks, the iPhone has a built-in obsolescence. After two years, customers not only go looking for a new deal, but

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ROLLINS: A DEFENSIVE LONG TERM VALUE PLAY

At Frontwater Capital, we aim to pick defensive-style stocks in the exact opposite manner in which we select our spouse or partner. Forget "sexy" The more boring the better!

ROLLINS (TICKER: ROL; $29.58 USD AS OF JUNE 30TH)

Today, it is not so easy to find quality stocks using the same criteria that legendary value investor Benjamin Graham used so many years ago. Global competition, constant innovation and obsolescence, as well as a lot more money chasing the market are just a few of the revolutionary changes in the past 85 years. But his two-pronged investment philosophy of preserving capital while earning a satisfactory return is still very much relevant.

One of the least sexy stocks out there is US based Rollins (ROL). With a market cap of $4.3 billion, ROL is the largest pest and termite control company in the world. (Getting aroused yet? I didn't think so.) It provides its services to over two million customers from more than 500 locations around the globe. It has achieved positive earnings and free cash flows in every single year for the past decade, right through some very rough economic times. (Sounds a little more interesting now?)

The closer you look, the better it gets. Rollins operates a nice recession-proof business servicing both commercial and residential customers. While both types of customers may defer certain discretionary purchases during an economic downturn, they are going to take the time and the dime to clean up a rodent and pest problem that's plaguing their home or business. It is simply too much of a health issue to ignore, and a huge reputational risk for those operating in the food, retail, lodging, and hospitality industries.

So Rollins has a solid and "essential service" for preserving your capital in any economy, but there is also some frosting for the cake to sweeten the return in better times. Its high recurring revenue level of 80% – a very positive factor to start with – leaves plenty of room for adding monthly subscribers who are not under immediate attack by two-foot sewer rats and just want the peace of mind of preventive treatments when they have the discretionary cash available.

"It generally is better to buy a wonderful company at a fair price than a fair company at a wonderful price."

If Rollins still hasn't garnered your attention just yet, hopefully this will sound downright attractive. The company's return on equity (ROE) and return on investment (ROI) last year were both an impressive 45%. Over the last five years, the company has grown earnings by 13% per year and dividends by a whopping 23%. While technically not a dividend champion just yet, Rollin has raised its distributions every year since 2002. Finally, the fact that the company is 100% debt free gives us plenty of comfort and "peace of mind" that this company, much like a Heinz, will be around for generations to come.

The shares may be a tad expensive, trading at 34 times earnings, but from a financial perspective there is still much to like about ROL. And in the words of Mr. Buffett himself, "It generally is better to buy a wonderful company at a fair price than a fair company at a wonderful price." There's a lot of wisdom in those words. It's also true that the non-flashy wallflower with the comfortable shoes and the nice personality sometimes makes a better partner for the long haul. FLT

Back in 1929, **Benjamin Graham** (legendary investor and teacher to Warren Buffet) recognized that there was wisdom in purchasing stocks that could be expected to hold their value and earn a reasonable profit. He realized that no matter how rigorous he was in his calculations, predicting the future was a risky business. Game-changing news could break at any time and without notice, which made everyone prone to making bad assumptions about the future. For this reason, Graham's emerging investment philosophy required that a stock must be trading at a significant discount to its intrinsic value – that way he could safely position himself in a golden zone he called the "Margin of Safety." And the world of value investing was born.

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
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- Customizing a Financial Strategy
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- Business Continuation Planning
- Protecting US$ Investments against Currency Risks
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- Structured Products
- Closed End Funds

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- 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

APPLE AND INTEL

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a new smartphone as well.

And for those with a little imagination, there are an endless number of new possibilities that could further drive AAPL's earning over the next 10 years including enhancements to Apple TV, iTunes, and mobile payments processing.

All too often though, judgements get clouded and investors lose their taste for the long term. The classic investment book, *Reminiscences of a Stock Operator*, writes: "A man may see straight and clearly and yet become impatient or doubtful when the market takes its time about doing as he figured it must do."

The point here is that investors often get caught up in the manic desire for instant gratification and finding the newest and hottest overnight millionaire-maker. And when we start reading the financial pages like they are *Entertainment Weekly* or *Variety*, we can miss the forest through the trees.

The perceived lack of innovation and the failure to launch the 'next big thing' caused many investors to flee AAPL and INTC. Although growth has slowed from the heady days when double-digit increases were the norm, there still appears to be much life left in Apple and Intel. FLT

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WHY INVEST IN GICS?

GICs are secure investments that guarantee your initial principal investment, while earning a fixed rate of interest over their lifetime. GICs offer predictable income and are the foundation of many balanced portfolios.

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- UNLIMITED deposit insurance protection by:
  - ✔ CUDIC of British Columbia
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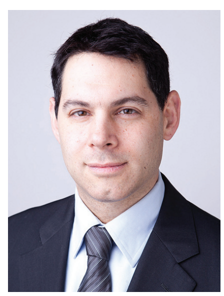
  - ✔ CUDGC of Alberta
- 1%-1.5% higher than average rates (see table*) from over 30 Canadian institutions

	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.08%	1.95%	1.95%	1.94%
2yr GIC	2.20%	2.20%	2.20%	2.10%
3yr GIC	2.27%	2.20%	2.20%	2.20%
4yr GIC	2.50%	2.35%	2.35%	2.35%
5yr GIC	2.70%	2.60%	2.60%	2.60%

*rates subject to change

JEFF KAMINKER, MBA, CFA founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). 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, Commodity Trading Adviser, and Exempt Market Dealer.

FRONTWATER CAPITAL

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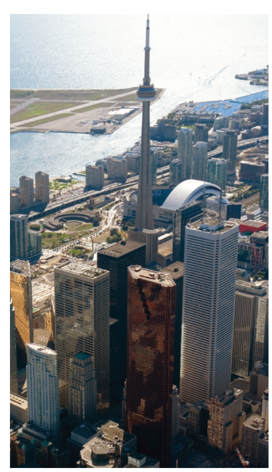

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