Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JULY 2, 2017

WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL

Economic Update

The U.S. and Canadian economic outlooks are starting to appear healthy again. It took nearly a decade but the plan to rejuvenate the economy like an Olympic athlete on steroids with low interest rates and cheap money is finally working.

Consumer confidence in both countries is at the strongest level observed in over eight years. With rising home prices and a rich stock market, people are feeling wealthier and are willing to put that new wealth towards luxury cars, home renovations, and other forms of discretionary spending

Businesses are also spending and putting their excess cash to work; home building, mining exploration, business equipment, have all experienced double digit growth. Unemployment in the US has dropped to 4.3 percent and 6.5 percent in Canada. GDP in both US and Canada is expected to grow near 2.2% in 2017. Meanwhile the estimated earnings growth rate for the S&P 500 is a robust 8.3% growth for Q2 2017.

Of course, it's not all roses for everyone. Most job growth is in low-paying retail and food service industries. Many workers are in part-time positions. And many people have been out of work for so long that there is zero possibility of them returning to their old high-paying jobs. Indeed the real unemployment rate in the US is closer to double the widely-reported unemployment rate.

Still, all in all, the world is starting to look a lot more hopeful for the next generation so much so that central bankers are talking up interest rate hikes in the near future.

THE CASE FOR PUT OPTIONS

While the economy is pleasantly going into overdrive, the stock market has been performing well for some time now. The last time the market suffered a near 10 percent drop was about 15 months ago, in April 2016. Ironically, rising markets tend to attract even more money, even though the best buy opportunities occur when the market is down. Nobody wants to miss out on a stock rally which is why the market often gets ahead of itself at times.

But if Noah had waited until the torrential downpour began before he started to build his ark, the story of mankind might have turned out quite differently, at least in this Biblical allegory. And there is reason to believe that we could at this moment be experiencing the calm before the storm. Here's why:

The forward price-earnings ratio on the S&P500 is currently 18.7, about 10% higher than the 20-year average. Meanwhile, the bond yield curve is flattening and credit spreads are narrowing, suggesting investors are mispricing risky higher yield bonds. Finally, the VIX is at its lowest point in 50 years suggesting volatility has all but disappeared.

These three indicators: the forward P/E, the flattening yield curve, and the record low VIX, taken together are cause for concern. Historically, market crashes have been preceded by low-volatility environments. And low volatility tends to signals investors' complacency and overconfidence. Even a minor crisis is enough to trigger panic sales and/or margin calls when investors aren't expecting it.

Fortunately, a few well-placed index put options can provide the umbrella for the rain that will inevitably come.

OPTIONS TO THE RESCUE

While today's environment makes it difficult for the traditional long-only portfolio manager to find bargains in the stock market, that's not true for option

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AMAZON BUYING WHOLE FOODS: A MATCH MADE IN INVESTOR HEAVEN...? NOT EXACTLY.

According to just about every Wall Street analyst out there, Amazon is set to re-write the rules on the grocery industry. We would throw caution into the wind on this union especially in taking advice from investment people who have never spent a day on the floor of a loading dock. Amazon is an excellent company but investors should not underestimate the company's lack of experience in the grocery industry.

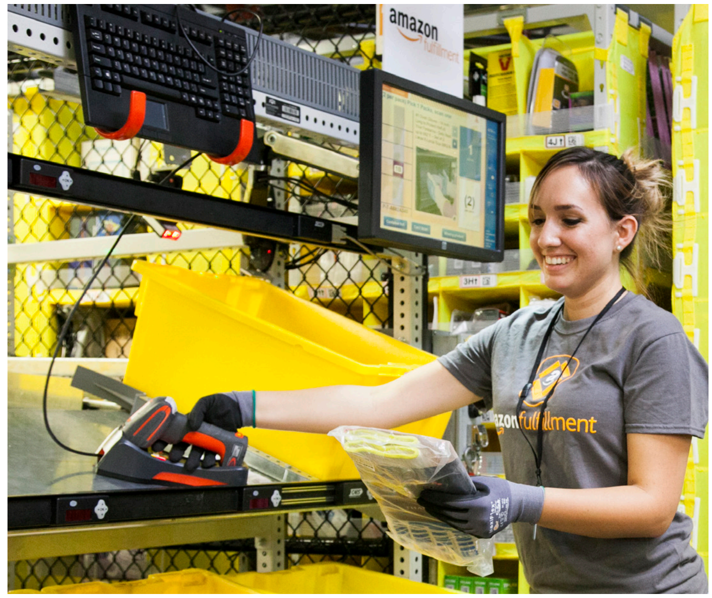

PHOTO: ERIC SLOMANSON / AMAZON

History has shown that shipping TVs is simply not the same as shipping fruits, vegetables, and cuts of meat. Some companies like **Grocery Gateway** are doing it today on a small scale basis but rolling out a system to a large mass audience is complex and cost prohibitive. Companies have yet to figure out how to efficiently pick items and then ship the product during daytime hours. Amazon may yet be the first but logic suggests it will take a lot more time than the analysts are expecting."

Let's be clear about one thing. Amazon is logistics and convenience, not merchandise. Amazon's value-add has been its ability to provide an online marketplace for buyers and retailers to come together to do business. In fact, much of Amazon is not even Amazon, it is FBA "Fulfillment by Amazon".

Along the way, Amazon has built an impressive and enviable supply chain system capable of distributing products within 24-48 hours of ordering. But those remarkable skills alone do not make Amazon equipped all of a sudden to become a leading grocery retailer. If it did, then other leading logistics companies like FedEx and UPS might as well jump into the fray.

Grocery retailers actually take physical possession of products and perishable goods and store them for days at a time – something which Amazon has little to no experience. Grocers' purchasing agents are skilled in negotiating deals with big multinational food companies. Grocers have specialized departments aimed at scouring the globe for high quality third-party manufacturers that make their private-label brands. Again, Amazon has nothing of the sort.

Also, we should never forget the first rule of grocery retailing still in existence today: "Location, location, location". Location remains the number one determining factor as to where individuals shop for their everyday items. Whole Foods controls less than 1.20% of the grocery market with only 450 stores in the US and 12 in Canada.

Of course, we can go all sci-fi and talk about a world in which people never leave their homes and drones are used to hand-pick and deliver groceries. But this utopian scheme is certainly far into the future – though it may well pay off for the Jestsons and Buck Rogers in the 25th century. Whole Food's limited presence is a major weakness that will be difficult to overcome.

Many investors likewise forget that it took Amazon a good 15 years to perfect its online marketplace, and there were many failures and flops along the way including the Amazon Kindle and the Amazon Fire Phone. One has to believe there will be a similar amount of hiccups and not the seamless integration that the market is predicting.

Bezos is also known for his long-term view, while "tinkering" and "trial and error" are all part of the gambit that serves the company well into the future. Bezos knows full well there will be daunting and potentially insurmountable obstacles. Good on him for being a calculated risk taker and it probably explains why he bought a smaller chain rather than a omnipresent industry leader.

Nevertheless, the acquisition does not seem to be a reason for hand-wringing or leaping from windows. We are not suggesting that Amazon is going to fall off a cliff, merely that there seems to be a bandwagon of exuberance over this deal.

As analysts wet themselves over the Whole Foods acquisition, we believe buying

PHOTO: KATE MEDLEY / WHOLE FOODS

opportunities are opening up in the retail space. Companies like Wal-Mart, Costco, TJ Maxx, and Loblaws should be on every investor's radar. These stocks were hammered falling about 5% on average when the news first came out and have been dropping ever since.

Whereas the acquisition of an information-based entity like the Washington Post can be easily transformed into an online presence, things like tomatoes, fish, and cottage cheese cannot be easily downloaded or even delivered into people's homes. Amazon has the skills and logistical chops to make the food chain profitable and transform it into even greater profitability. We just think this odd pairing will take longer to integrate than the market is expecting.

A RARE OPPORTUNITY TO BUY AN EXCELLENT COMPANY AT A FAIR PRICE

With the stock market at an all-time high, finding stocks with a high conviction rate can be a difficult undertaking. But such is the case with Costco (COST). Down more than 10% in the last two weeks, Costco is getting wrongfully punished in the aftermath shockwaves of the proposed buyout offer of Whole Foods by Amazon.

PHOTOS: COSTCO

TICKER COST, PRICE: $159.93 AS OF JUNE 30, 2017

Investors are putting way too much faith that the shake-out in the grocery industry will happen overnight. Costco is a far different beast altogether than most grocery retailers. Its proven business model which relies on bargaining power, customer-friendly packaging, supply chain efficiencies, and a no-frills shopping environment is not so easy to penetrate.

Costco pioneered the warehouse club retail model back in 1983 with its first warehouse store located in Seattle. Over a span of six years, Costco grew sales from zero to $3 billion, an incredible feat. Originally, Costco served only small businesses, but the company found it could achieve far greater buying clout by servicing a larger customer base. Today, Costco is a shopping destination for consumers across all income levels, as well as small businesses. Don't believe me? Just go to any Costco location and count the number of Mercedes, BMWs, and Porsches in the parking lot.

Margins are inherently low, as Costco only marks up its products by approximately 12% — about half the mark up of traditional grocers, such as Krogers and Wal-Mart. By passing on the savings to everyday customers, Costco has built up a loyal membership base with annual retention rates that exceed 90%. This membership base drives profitability, as nearly 75% of Costco's earnings come from its membership fees.

Equally impressive is Costco's low cost structure. The company reduces handling costs by purchasing merchandise directly from manufacturers and shipping it straight to the warehouse store rather than to a central warehouse. The company has also streamlined its product categories. Rather than overload customers with a myriad of choices, Costco keeps things simple with 3-4 high quality choices within a product category. Unlike a Loblaws which deals with tens of thousands of products, Costco typically only maintains around 3,800 stock-keeping units, which significantly simplifies the purchasing and delivery processes. Best of all, no shelving is required. Throw the pallet onto a forklift, tear away the shrink wrap, and away it goes onto the sales floor.

Costco's 727 warehouses, with an average square footage of 145,000, generate over $123 billion in sales. If you do the math, this translates into more than $1,100 net sales per square foot. By comparison, Wal-Mart is close to $400, Target is $300 and Sam's Club is around $650. That is what we would call domination on the part of Costco.

Financially, it is true that Costco's shares continue to trade at an expensive forward earnings multiple of 24, even with the 10 per cent drop in share price. At the same time, a high price earnings multiple seems justifiable given Costco's historical track record of growing revenues and earnings in the double digits.

Return on equity is impressive at 23%, and the company's debt of $4 billion is certainly manageable for a company with a market cap of $60 billion. Income-oriented investors can also come to appreciate Costco. The dividend yield on the stock currently sits at 1.27% but the company has a track record of paying out large special dividends every few years. In December 2012, the company offered a $7 special dividend. In May 2015, it paid a $5 special dividend, and just this past May, the company paid out another $7 dividend.

For long term shareholders Costco's business model has possible growth opportunities through global expansion and e-commerce. We estimate that only about 4% of Costco's revenue is derived from online sales. If Costco is able to effectively improve their e-commerce capabilities, they will stay competitive in this ever-changing retail environment due to the simple advantages of their "low price, high quality" strategy" that has shaped their defensive economic moat.

Don't wait too long — the Whole Foods fascination will dwindle, and the market will realize that Costco is going to keep marching forward

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 (Offered thru WDBA and Associates)
- Alternative Assets

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

ECONOMIC UPDATE

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traders. Whereas long-only portfolio managers might come home empty handed from their trip to the bazaar, option traders are still pretty much guaranteed to walk away with something.

Our most exciting trade continues to be our purchase of index put options. We continue to layer on 45-60 day 'insurance' in our non-registered accounts to hedge against a large drop in the stock market. While most investors rarely get excited about the notion of adding put option 'insurance', we are absolutely thrilled about the opportunity to mitigate risk at bargain basement prices.

In essence, the put option strategy is a volatility strategy that gives us the best of both worlds: upside potential in a rising market with downside protection. Long volatility positions help smooth the risk profile and are an important component to improve the risk-return profile of our portfolios. With 'insurance' on the books, we can sleep peacefully at night knowing there are mechanisms in place to deal with a potential falling market.

Guaranteed Investment Certificates (GICs)

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.

HIGHER RATES, SAME RISK

As a deposit broker representing over 30 financial institutions across Canada, we are able to offer our clients personalized service at a lower cost.[1] This means that the savings get passed along to you through higher interest rates with the same principal guarantee that all GICs provide.

BENEFITS OF OUR GICS:

In addition to offering CDIC protected GICs which provide protection up to $100,000, we also offer GICs with:

- UNLIMITED deposit insurance protection by:
  - ✔ CUDIC of British Columbia
  - ✔ Deposit Guarantee Corp. of Manitoba
  - ✔ CUDGC of Alberta
- 1%-1.5% higher than average rates (see table*) from over 30 Canadian institutions [2]

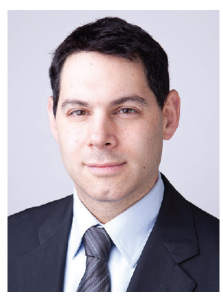
	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.10%	1.50%	1.50%	1.50%
2yr GIC	2.12%	1.65%	1.65%	1.65%
3yr GIC	2.15%	1.80%	1.90%	1.80%
4yr GIC	2.17%	1.90%	1.95%	1.90%
5yr GIC	2.25%	2.05%	2.05%	2.05%

* Rates subject to change

[1] Frontwater does not issue GICs. GICs are issued through independent, third-party financial institutions.

[2] Based on comparable posted rates as of June 30, 2017 at Canada's five largest financial institutions..

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

VISIT WWW.FRONTWATER.CA

Contact us for a complementary consultation at:

416-903-9195 | 416-890-4717

or:

Invest@Frontwater.ca

1920 Yonge Street, Suite #200

Toronto, Ontario M4S 3E2