Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | OCTOBER 1, 2019

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FRONTWATER CAPITAL

The Sky is ... Falling?

The Fed lowered interest rates by 25 basis points this past August. My good friend and wall street analyst, Chicken Little, tells me that this means the economy is in big trouble. I should sell everything right away...? *Not so fast...*

It's true that the fundamental backdrop for the global economy looks to be on shaky ground for the first time in 10 years. But there's a bigger picture to consider here. Before we all panic and dump our shares, let's remember a few things: This small interest rate drop comes in the wake of six consecutive rate hikes. A little tweaking is sometimes necessary to get things just right.

Moreover, it was only ten months ago when the market panicked dropping more than 25% after Fed Chairman, Jerome Powell, talked about a booming US economy and raising rates 4 times in 2019. Cash investors who sat on the sidelines missed out on the biggest global stock market rally in nearly three decades.

Today, the main chatter at the Federal Reserve revolves around the slowing global economy. Indeed, the Feds have reversed course by lowering rates and updating their forecast to "gloomy with a chance of recession". Overseas, Mario Draghi has similarly engaged in another round of quantitative easing for the EURO and the global data seems to support this theory.

Global GDP remains at 3.6% and is expanding at a snail's pace. China's economy grew at 6.2% - its lowest quarterly growth in 27 years as the country feels the effects of the trade war drag. We saw similar economic weakness in the US and Europe.

The ISM Manufacturing PMI, which is considered one of the best indicators for economic growth in the US, fell in July, August, and September causing third quarter estimates for the U.S. GDP to fall from 2.3 to 2.0. The August reading of 49.1 pointed to the first month of contraction in the US manufacturing sector since January 2016.

Germany, Europe's largest economy and the world's fourth largest, said its economy shrank last quarter. Finally, here in Canada, the outlook for business investment is weak. Businesses are expressing a great deal of pessimism about their future spending.

OFFICIAL WHITE HOUSE PHOTO BY SHEALAH CRAIGHEAD

President Donald J. Trump and First Lady Melania Trump, joined by President Xi Jinping and First Lady Peng Liyuan, right, are given a tour, Wednesday, November 8, 2017, of the Forbidden City in Beijing.

So...on the one hand, with slowing economic growth all around the world, the stock market is likely more susceptible to bouts of volatility, especially with international trade tensions on the rise. But on the other hand, slow growth here is better than the contracting economies abroad, which means that the U.S. market remains a magnet for investments from around the world.

With bond yields at historical lows and negative in many cases, income-chasing investors have few places to shelter their money. In countries like France, Germany and Switzerland, the 10 YEAR federal bond rate is actually negative. Retirees are having to pay their banks to hold onto their cash. Thus, in spite of the economic outlook, it makes sense to stay the course with an overweight allocation tilted towards equities.

Unfortunately for retirees and those dependent on interest income, the stock market remains the only game in town. High quality dividend-paying stocks like JP Morgan or CVS with dividend yields in the range of 3% remain highly attractive, especially in the face of other

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HOW TO BUILD A BETTER BOND PORTFOLIO WITH THESE TWO EQUITIES

Bond yields have been unkind to savers and fixed income investors alike. Retirees hoping to play 18 holes at Augusta may instead find themselves staring at a big clown face or a spinning windmill at the local putt-putt course.

The returns on bonds seem hardly adequate given that investors need to concern themselves with credit and interest rate risk. 10 and 30-year US government bonds yield a mere 1.65% and 2.10% respectively. Even a high quality Canadian corporate bond has an average yield to maturity of just 3.21%.

Income investors' best bet right now is turning to a few dividend-paying stocks in a couple of slow growth industries. Tobacco is one of those industries where the threat of new competition is low, revenues are relatively stable, and the industry can sustain itself for years to come.

THE TOBACCO INDUSTRY

> "I'll tell you why I like the cigarette business. It costs a penny to make. Sell it for a dollar. It's addictive. And there's fantastic brand loyalty."
>
> —Warren Buffett, quoted in *Barbarians at the Gate: The Fall of RJR Nabisco*

Buffett himself does not actually invest in tobacco companies. Tobacco ownership comes with a lot of PR headaches. At this stage in life, better to take the high road and avoid the frustrations. Nonetheless, the business models for the cigarette companies continue to be a compelling one for the non-uber rich investor like most of us.

Cigarette companies have been battered endlessly over the past decades, and recently a merger plan between Philip Morris and Altria was dropped after the companies could not agree on a final split. However, only a few rare public companies have huge profit margins of near 30% with a corresponding low-price earnings multiple in the 9-14 times range. Phillip Morris and Altria are two of them.

Let's begin with some very positive news about the smoking industry – a disgusting habit and one of the worst cost pressures to our medical system. Cigarette smoking in North America is very much in decline. Where 42% of the US adult population smoked 50 years ago, only 14% do today. Yet due to nicotine's addictive qualities, the cigarette companies are able to pass through price hikes enabling them to continuously expand their earnings. Altria has already raised prices twice so far this year in 2019, and some are expecting a third rate hike.

The other two interesting developments in the tobacco industry are electronic cigarettes and heated tobacco units.

"An electronic cigarette or e-cigarette is a handheld battery-powered vaporizer that simulates smoking and provides some of the behavioral aspects of smoking, including the hand-to-mouth action of smoking, but without burning tobacco. Using an e-cigarette is known as 'vaping' and the user is referred to as a 'vaper.'"

— Wikipedia

"Heated tobacco products heat up tobacco using a battery-powered heating system. As it starts to heat the tobacco, it generates an aerosol that contains nicotine and other chemicals, that is inhaled. Heated tobacco products are different from electronic cigarettes because the latter heat up and vaporize a liquid, which usually contains nicotine, while the former heats actual tobacco. Philip Morris claims that, because the tobacco does not burn, heated tobacco releases much lower levels of the harmful chemicals typically found in tobacco smoke. So far this claim has yet to be proven."

— Wikipedia / Phillip Morris

PHILLIP MORRIS (PM) AND ALTRIA (MO)

TICKER: PM PRICE AS OF SEPT 30, 2019: $75.93
TICKER: MO PRICE AS OF SEPT 30, 2019: $40.90

Both Phillip Morris and Altria have dominant pricing power because of proprietary taste, fantastic brand loyalty, and almost zero competition. All these qualities provide the necessary economic moat that allows each of them to raise prices ahead of inflation and cost of materials.

Unlike the supermarket industry, which has spawned large numbers of generic and private label brands (ie. Noname, Presidents Choice, Sam's Club, Kirkland, etc), the same is not true of the cigarette industry. Perhaps it's because few companies like Loblaws, Walmart or Costco actually want to be associated with tobacco. Regardless, generics have not made a dent to the industry as with other consumer products and the two companies remain highly profitable and cash flow positive. Both companies have compelling valuations.

Phillip Morris owns the international rights and operates one of the most widely recognized brands in the world, Marlboro. The company itself was spun out of Altria in 2008 and consisted mainly of Altria's international operations as the time. It has a 14.6 percent market share of the global cigarette market, second only to China National Tobacco Corporation. The company generates $29.5 billion of sales each year. $25.5 billion comes from its traditional cigarette business and $4 billion comes from its heated tobacco product which the company only started selling in 2016. Thus, the heated tobacco product looks to be very much a success story as shipment for the product continues to increase due to demand for non-combustible options.

The company is highly profitable with profit margins of 27% and gross margins of 38%. Moreover, the company trades at a respectable 13.5 forward price earnings ratio and pays a 6% dividend. Its payout ratio is only 90%, so the company is still cash flow positive even after the payout which is why we love this dividend!

Altria operates primarily in North America and commands a 50% share of the U.S. cigarette market dominated by high-priced premium brands such as Marlboro, Benson & Hedges, and Skoal. Altria has an astounding 51% operating margin, 32% profit margin and a forward price earnings ratio of 9.5. While we can all take comfort knowing that the smoking rate in the US is on the decline, Altria is still far from a dying business. At those valuations, the market is pricing Altria to disappear within the next decade.

Altria pays out 95% of its earnings to shareholders via its dividend, leaving not much leftover for reinvestment and growth. But with a dividend yield near 7.8% and a perfect track record of consistently raising its dividend over the last 50 years, investors can sleep at night owning this stock. By comparison, bonds held to maturity do not allow for any growth and those bond yields only return half as much. And bonds don't pay you cash every quarter.

ANHEUSER-BUSCH
Companies

Finally, let's not forget that Altria also owns 185.1 million restricted shares of Anheuser-Busch, InBev representing a 9.6% economic and voting interest in the company. With Ansheuser Busch (ticker: BUD) currently valued at approximately $180 billion, that stake alone is worth just under $18 billion.

That said, Altria has made a couple of very questionable investments in the last 12 months. They entered the marijuana industry late in the game by investing approximately $1.8 billion USD this past March in Cronos, a Canadian weed company. This effectively gave them 45% ownership in Cronos but today, this investment is worth only about $1.00 billion USD.

While their timing on Cronos was questionable at best, their decision last December to buy a 35% stake in Juul for $12.8 billion USD was outright horrendous. The deal valued Juul at over $38 billion USD despite only $1.5 billion in revenues, nearly 23 times sales. By comparison, Altria trades at 4 times sales.

Today, Juul is in the crosshairs of many governments who rightfully view it as an epidemic and major public health risk. Data shows that over 3.6 million high school and middle school students in the United States had used e-cigarettes in 2018 — a huge spike from the previous year. The Trump administration has directed the FDA to take a harsh stance on vaping, potentially banning flavored vape products across the country. Moreover, as of August 2018, Israel was the first country to place an outright ban on Juul, citing the public health risks. One has to wonder if more countries will follow suit.

As bad as the Cronos and Juul investments were, neither transactions are fatal. Altria was in financially great shape prior to these transactions. Of course, these two transactions reflect very poorly on Altria's management and is a main reason why the stock has plummeted 35% from $60 per share to $40 today over the past twelve months. But the company will survive.

At today's price level, Altria seems like a real bargain. Investors have wiped out over $16 billion of market cap in the last year which is more than the price tag of Cronos and Juul combined. That would seem a little irrational to us at Frontwater which is why Altria popped up on our radar.

Yes, it's true that interest rates on bonds are guaranteed ahead of time, and dividends are announced as they are paid. However, when interest is just a smidge above zero and these high-end dividends have decades-long track records of reliability, it might be worth a long look-see for even the most risk-averse investor. Going forward, both Phillip Morris and Altria are touted as the prototypical recession resistant stocks.

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
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- Structuring of Family Wealth
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- Protecting US$ Investments against Currency Risks
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PRODUCTS

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- Income Trusts
- Initial Public Offerings (IPOs), new issues
- Derivatives (Calls, Puts, Futures)
- Commodities
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- 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

THE SKY IS...

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fixed income alternatives.

Moreover, the gloomy outlook could literally evaporate overnight. Our economies here in North America are experiencing stormy weather, not climate change. There is a strong belief that Trump will get a deal done with China, perhaps quite soon. Trump is a wizard at market timing and, while it's probably too early to finalize a deal just yet, we see a deal getting done some time in the next few months. We believe his best bet is to negotiate a deal with China in December, just before the election year begins and right in the middle of impeachment proceedings.

As to whether or not Trump can survive an impeachment is a different story, depending on who you ask. That said, every other time that Trump looks like he is "down for the count," he amazingly finds a way to bounce back. The impeachment process may be holding the economic reins in a bit, but it is certainly not tanking the economy. And it is clear that central banks have adopted a dovish stance.

In terms of our fourth quarter expectations, we expect the markets to be volatile as analysts debate back-and-forth about the global economy. From a risk/return perspective, we continue to believe that high-quality dividend stocks paying a dividend yield of 2-3% offer the best reward for investors in the marketplace. It seems to us that the economy is in check, and not hemorrhaging its lifeblood. The sky is not falling.

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]

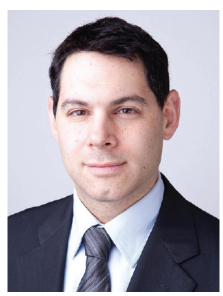
	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.36%	2.21%	2.21%	2.21%
2yr GIC	2.39%	2.32%	2.32%	2.32%
3yr GIC	2.39%	2.35%	2.35%	2.32%
4yr GIC	2.37%	2.35%	2.33%	2.35%
5yr GIC	2.50%	2.40%	2.40%	2.40%

* 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 Sept. 30, 2019 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.



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