January 2015

"If everyone is thinking alike, then somebody isn't thinking."
-George S. Patton Jr.

The Future Isn't What It Used To Be

At this time of year, we are often asked how we think the stock market will perform in the year ahead. While one can talk about whether markets appear cheap or expensive, the reality is that no one can forecast with any meaningful accuracy what lies ahead for investors over the next twelve months.

Sell-side analysts and economists are forever making predictions -- often bold headline grabbers -- in order to gain attention. Many investors yearn to find a guru with a crystal ball who can provide the certainty they need to put their minds at ease. Alas, aside from the usual family photos, a few books and a list of the five worst investments that I made in my career (so that I will hopefully not repeat them), there is no crystal ball to be found in my office.

While we intuitively know that no one can predict the future with any assurance, humanity seems to be drawn to those who make their predictions seem like a foregone conclusion. It was only a few years ago that Bay Street economist Jeff Rubin wrote the following in a research report, right before oil fell some 70%, from approximately $140 to $50 per barrel:

> ***"We are compelled to … raise our target prices for oil… to an average price of $200 per barrel by 2010." (CIBC World Markets, June 26, 2008)***

To be fair, he was hardly the only analyst predicting permanently high oil prices. Much of the investment world was caught up in the theory of "peak oil"; the idea that oil supply would be in long-term decline, while demand would be rising, resulting in a secular bull market for oil.

As recently as September, with oil around $90 per barrel, a Wall Street Journal poll found that:

> ***"Indeed, a majority of economists don't believe global oil prices will change over the next six months as a result of turmoil in the Middle East. One-third said the instability might lead to a slight increase in oil prices." (WSJ, September 11, 2014)***

Today, with the price of oil below $50 per barrel, the major Wall Street firms have dramatically reduced their oil price "forecasts," employing the usual charts and smart sounding analysis to give the impression that their predictive abilities have merit.

The reality is that Wall Street analysts base so much of their research reacting to trends, and their forecasts usually suggest that such trends will simply continue. In other words, if the price of oil is rising, then the consensus forecast is for a continued rise, and vice versa. Most Wall Street recommendations and forecasts reflect a herd mentality and this ends up dominating investor behaviour, creating opportunities for those who are not afraid to question the consensus.

An oft-cited study on forecasting (by the CXO Advisory group) gathered and tracked the results of over 6,000 predictions from 68 investment gurus between 1998 and 2012. ***The average guru was accurate just 47% of the time.*** *In other words, they would have had more predictive success by tossing a coin. (source: http://www.cxoadvisory.com/gurus/)*

The Year Ahead

While we remain cognizant of a number of risks that may impact equity markets, given my comments above, you will certainly not find any forecasts here!

The U.S. economy is improving faster than most. While the Fed is contemplating raising interest rates, most other central banks are grappling with sluggish growth and fears of deflation. The strength of the U.S. dollar, if it persists, will put pressure on U.S. corporate profits – certainly not a positive for the U.S. equity markets.

Europe is following in the footsteps of the Fed and is embarking on the path of quantitative easing (QE) in an effort to stimulate investment. Years of austerity have resulted in lower European budget deficits, but the citizenry is growing tired of elevated levels of unemployment and belt tightening. The good news is that as the deficit situation has improved, European governments will be able to step up spending over the next few years, which is usually the best tool to bring about renewed economic growth.

After its own QE program over the past two years, Shinzo Abe, Japan's Prime Minister, has promised to implement the so-called "third arrow" of his strategy: structural reform. This will not be an easy task, but there are limits to the effectiveness of further QE and there is not much room for further fiscal stimulus, given the country's high debt level.

China and other emerging markets have experienced decelerating growth, which has been putting pressure on commodity prices. This is good news for much of the world, but not for Canada. The sudden drop in the price of oil is already impacting the federal budget balance and, of course, Alberta is suffering. The major energy companies have already announced significant job cuts, and capital spending in the Canadian energy sector will be reduced by over $20 billion this year. All of this will reverberate throughout the Canadian economy, as construction activity, bank lending and the housing market are all somewhat tied to the energy sector.

If all of the above were not enough, ongoing geopolitical issues including the Greek election, political gridlock in the U.S. and the struggling global economy, suggest that we may experience continued market volatility in the year ahead, which will hopefully lead to attractive investment opportunities.

"Banking" on Value

While many areas of the market have rallied strongly over the past couple of years, one sector that has lagged is the European banking sector. Many of the larger banks in Europe trade near their 52-week lows and at seemingly cheap valuation multiples. There are several reasons for this.

One major issue relates to mandatory capital requirements. In the aftermath of the financial crisis, financial regulators have introduced more stringent capital rules for the global banking sector. As a result, many of Europe's larger banks have been forced to raise equity in order to bring their capital adequacy ratios up to the required levels.

Another reason is the litigation issues that many of them face. A number of European and U.S. banks, including UBS, Citigroup, RBS, JP Morgan, Barclays and Deutsche Bank, have already been fined for misdeeds ranging from manipulation of LIBOR, foreign exchange and gold markets, to conducting business with countries which are restricted under the *Trading with the Enemy Act*. BNP Paribas, the largest French bank admitted to violating U.S. embargoes against Sudan, Iran and Cuba in a U.S. federal court, and agreed to a record $9 billion settlement. While various investigations are ongoing, it appears that these companies have learned their lesson, at least for now.

Recent Purchases

Deutsche Bank

We recently initiated a position in Deutsche Bank (DB), Germany's largest bank. Despite facing some of the same regulatory and litigation concerns as described above, DB has spent the last few years rebuilding its balance sheet and positioning itself for the new regulatory regime.

Following a large rights issue that was completed last year, Deutsche Bank enters the new year with a stronger balance sheet, and should have adequate capital to deal with its remaining regulatory issues. With its finances in better shape, management's focus has returned to improving its core business units. The shares trade at half of tangible book value (a measure of liquidation value) and earnings are poised to rise. At the present share price, there appears to be a healthy margin of safety, along with a dividend yield of 3.1%.

Nippon Pillar Packing

Nippon Pillar Packing was founded in 1924 and manufactures fluid control-related equipment, such as mechanical seals and fluorine resin products used for pumps, mixers, valves and other general industrial equipment. Its customers operate in a wide variety of sectors, including companies in the automobile, refining, construction and semiconductor industries. Nippon Pillar's exports have been growing and will benefit from the weaker yen. With stable margins, consistent profitability, healthy free cash flow generation and virtually no debt, the company maintains a very strong balance sheet. Its shares are also compellingly cheap, trading for less than tangible book value and close to net-net working capital (that is, current assets minus all liabilities), and paying a dividend yield of 1.8%.

High Yield Bonds

A review of the high yield bond market and our high yield fund is available here: High Yield Quarterly.

Final Thoughts

Following the crowd and reacting to events that have already occurred is probably not the best strategy for investment success.

We remain steadfast in our approach, focusing on underlying value, while ignoring consensus thinking. The result: a compelling portfolio of undervalued companies that offers ample opportunity for growth, while minimizing risk.

Admittedly no strategy is perfect, but until we find a crystal ball, value investing is the best way to go.

We wish you peace and good health for 2015, and are always available should you have any questions.

Sincerely,

Lorne Steinberg
President