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Taking Advantage of Market Volatility in Q1

North American stock markets experienced considerable volatility during the first quarter of 2016 (Q1), with a sharp downwards move to begin the year, followed by a substantial rally. We touched upon some of the reasons for this in our Q4 2015 edition, published in late January. While sharp declines are unpleasant to endure, they do create long-term opportunities. If a high quality company with good long-term fundamentals declines sharply in value for short-term reasons, there may be an investment opportunity. We found several investment opportunities of this nature in Q1, and we will highlight them in this edition.

Before we discuss our Q1 investments, we would like to note that clients can access our Q4 2015 Newsletter online as well as other archived quarterly Newsletters. Please visit www.pasfinancialgroup.com and select "Our Articles" – "Most Recent Articles." This section of our website also contains some very recent content, including articles on Under Armour Inc. (NYSE:UA) and Ferrari N.V. (NYSE:RACE).

Buying REITs at Discounted Levels

A typical publicly-listed Canadian real estate investment trust, or "REIT", is a diversified portfolio of commercial properties contained within a trust structure. We have owned REITs in the past, but not all clients will be familiar with them. A REIT's units can be bought and sold by investors just like the shares of a regular public corporation. REITs are typically owned by income-oriented investors, as they often pay attractive cash distributions on a monthly or quarterly basis. In addition, REITs have some tax advantages over regular corporations, as they are generally not required to pay Canadian income tax if they distribute all of their taxable income to unitholders.

In February, we added REIT investments to the Total Return Portfolio and High Yield Portfolio. Certain REITs became attractive to us because the unit prices had dropped substantially, providing an attractive entry point. Canadian REITs in general are facing some headwinds in the form of economic weakness and somewhat weaker occupancy, but the particular REITs we are buying are large, well-established businesses that we believe will successfully navigate this environment.

Canadian Real Estate Investment Trust (TSX:REF.un) was a nice addition for both the Total Return Portfolio and High Yield Portfolio. We paid $40.88 per unit on February 19. Canadian REIT owns and manages a diversified real estate portfolio consisting of retail, industrial and office properties throughout Canada. It has been listed on the Toronto Stock Exchange since September of 1993, and it has a long track record of delivering solid returns for unitholders. It pays a distribution of $1.80 annually, which represents a 4.4% yield at our entry price of $40.88. That yield is actually somewhat low for a Canadian REIT, but we are content with it, as Canadian REIT is known for being conservative in its use of leverage and in the amounts it distributes to unitholders.

Also on February 19, in the High Yield Portfolio, we added a 3% weighting in Riocan REIT (TSX:REI.un) at a price of $25.41 per unit. Riocan is one of Canada's largest REITs. It focuses on stable, low-risk Canadian retail properties, particularly in the large metropolitan areas such as Vancouver, Calgary, Edmonton, Toronto, Ottawa and Montreal. These areas tend to have higher density and higher income residents, making them attractive to retail tenants. Riocan pays a distribution of $1.41 annually, which represents a 5.5% yield at our entry price of $25.41.

On February 25, 2016, we added to our position in H&R REIT in the High Yield Portfolio at a price of $18.71 per unit, giving H&R a weighting of approximately 3% in the portfolio. H&R is also one of Canada's largest REITs, with a diversified asset base that includes high quality office, retail, industrial and residential properties across Canada and the United States. H&R pays a distribution of $1.35 annually, which represents a 7.2% yield at our recent entry price. 7.2% is significantly higher than the 4.4% yield we are receiving on Canadian REIT and the 5.5% yield on Riocan. The reason investors are demanding that level of yield from H&R is that it has significant exposure to the Calgary office market, which is currently weak. We are comfortable with H&R's occupancy risk at the price we paid.

Adding To Our Energy Weighting

In 2015, we were generally content to maintain energy sector weightings that could be described as significant, but somewhat underweight relative to the S&P TSX Composite Index. In Q1, we have incrementally increased our energy sector weightings in the Total Return Portfolio and High Yield Portfolio, believing that WTI crude oil prices in the low US$30s or high US$20s are simply not sustainable for much longer.

It is likely that many oil producers will simply stop investing in new production, lacking the incentive to deploy additional drilling rigs. For example, on April 1 we learned that the number of U.S. oil drilling rigs in operation (the rig count) has fallen to the lowest level since November 2009.[1] The rig count is 55% lower than at this time last year. While this is U.S. data only, the U.S. has been the source of a significant amount of production growth over the past several years, contributing to lower global oil prices.

Generally, when a cyclical industry is in its down cycle, as energy is currently, our bias is to be buyers of high quality companies in that industry. In our Total Return Portfolio, on February 10, we added to our position in Suncor (SU:TSX) at a price of $30.22, giving it a weighting of just over 4% of the portfolio. Many clients will already be familiar with Suncor, as it is Canada's largest integrated oil company, with an impressive portfolio of assets. In addition to current operational strength and stability, Suncor possesses solid growth prospects due to its large asset base. The company also has a long history of dividend growth. We also like the recent acquisition of Canadian Oil Sands (COS:TSX), which increases Suncor's ownership interest in the massive Syncrude oil sands project from 12% to 48.74%.

Also during Q1, we purchased Vermillion Energy Inc (VET:TSX) at $35.10 in both the Total Return Portfolio and the High Yield Portfolio. Vermilion is a Canadian energy producer with good growth prospects and a variety of oil and natural gas assets in North America, Europe and Australia. Vermilion's current dividend rate gives it a payout of $2.58 annually, or a yield of just over 7% at our purchase price.

We will also mention some recent developments at TransCanada Corp. (TSX:TRP), as many clients own the stock. On March 17, TransCanada announced that it will acquire Columbia Pipeline Group for US$13 billion. Columbia operates approximately 24,000 km of natural gas pipelines extending from New York to the Gulf of Mexico. Many of their pipelines provide access to regions with growing natural gas production in the Northeastern U.S. TransCanada projects that the acquisition will add to its earnings per share in the first year and will add US$7.3 billion of new commercially-secured projects to its growth plans.[2] A month prior to the acquisition, on February 19, we purchased a 2% position in the company in the Total Return Portfolio. We also continue to hold a 4% weighting in TransCanada in the High Yield Portfolio.

Adding Growth and Diversification with Zoetis

Zoetis Inc. (NYSE:ZTS) is something different for us and for clients. This company is a global leader in the field of animal health medicines and vaccines. There simply are not many investments we can access for clients in this sub-sector.

Zoetis has a long history, as it was formerly part of the pharmaceutical giant Pfizer Inc. (NYSE:PFE). In 2013, Pfizer spun Zoetis off, and it became an independent public company. We pay close attention to high quality spinoffs, as they can become excellent investments. It is easy to understand why. In a large company with multiple business units, management may not be able to give every business the attention it deserves. In a new, smaller and highly-focused spinoff, there is increased management focus and incentive, which can lead to better business performance.

On March 4, 2016 we established a 2% weighting in Zoetis in the Total Return Portfolio. We paid US$40.90 per share, which is 23 times analysts' US$1.78 consensus estimate of earnings per share for 2016 and 18 times analysts' US$2.24 consensus estimate of earnings per share for 2017.[3] We believe the company's quality and growth prospects justify the valuation.

Zoetis has many of the characteristics of a high quality business, including a long operating history, a leading competitive position in its industry and high profitability. It also has a diversified line of products, and a promising research and development program. In a recent research report on Zoetis, Credit Suisse noted that it requires substantially less time and resources to commercialize a new chemical entity in animal health, given limited need for complex, lengthy human clinical trials.[4]

We believe the company has the potential to grow its earnings at double digit annual rates for the next several years. We also believe that the company's position in the animal health industry has diversification value to the Total Return Portfolio, as we do not own any related investments. Zoetis does pay a small dividend, but with strong growth prospects and a yield of less than 1%, it is best suited for the Total Return Portfolio and not truly a candidate for the High Yield Portfolio. Our intention is to hold shares of Zoetis as a multi-year, growth-oriented investment.

Taking Profits in SNC-Lavalin

Over the past several years, Canadian engineering firm SNC-Lavalin Group Inc. (TSX:SNC) has faced several challenges, including commodity price weakness, occasional poor financial results, and, of course, widely-publicized corruption charges relating to transactions in Libya. Throughout this period, we have viewed the company as a high quality engineering firm that will ultimately transcend its short-term issues. On a few occasions, we have purchased SNC shares for clients below or just above $40 and then achieved double digit returns by selling closer to $50 and collecting the 2%+ dividend during our hold period. We recently seized an opportunity to do this again.

In early March, SNC reported better than expected fourth quarter profits, driving its shares sharply higher.[5] We sold our position in the Total Return Portfolio at $46.52 on March 4 and our position in the Balanced Portfolio at $46.88 on March 10. We will continue to follow the company, in case a short-term selloff creates another buying opportunity. While the company's legal troubles are not entirely behind it, it may benefit from Canada's planned federal infrastructure stimulus.

Managing Currency Risk

On top of the recent stock price volatility, we have faced volatile exchange rates between the Canadian dollar and U.S. dollar. From our perspective, there are probably over 1,000 high quality companies to follow in the U.S. markets and less than 200 in the Canadian markets. In December and January, when the Canadian dollar was very weak, our investment options were narrowing. We did not want to buy U.S. investments at that point with a Canadian dollar trading near US$0.65, as the currency risk seemed too high.

As mentioned in our Q4 Newsletter, we dealt with the extreme lows in the Canadian dollar by trimming some profitable U.S. dollar-based investments and converting the U.S. dollars on settlement back into Canadian cash. We did not do anything drastic. It was simply an incremental change towards more Canadian holdings.

Recently, the Canadian dollar has rallied back to around US$0.76. This reduces returns on our U.S. holdings in the short term, but it does reopen our window to access the numerous high quality companies we research in the U.S., such as Zoetis, which we discussed above.

Conclusion

Despite the volatility in Q1, our three discretionary portfolios (Total Return, High Yield and Balanced) are well-positioned for the remainder of the year. We are always looking for ways to take advantage of market volatility to generate higher long-term returns, and 2016 has already offered up some opportunities.

Thank you for reading our Q1 Newsletter. We look forward to communicating with you and answering any questions you may have about our discretionary model portfolios, your personal circumstances, or other topics of interest. As always, we thank you for your business.

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APPENDIX "A"

DISCRETIONARY MODEL PORFOLIOS

We encourage clients to contact us for more information regarding our three fully discretionary model portfolios, namely the Total Return Portfolio, the High Yield Portfolio and the Balanced Portfolio. Our research efforts are now primarily devoted to finding investment ideas that will suit the criteria established for these portfolios and contribute to their returns.

1) Our Total Return Portfolio is focused on providing clients with an average annual return of around 8-10%, consisting mainly of capital gains and dividends.

2) Our High Yield Portfolio is focused on providing income-seeking clients with an average yield of 4%, plus around 2-3% of annual capital growth.

3) Our Balanced Portfolio is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

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[1] http://seekingalpha.com/news/3171023-u-s-oil-rig-count-10-baker-hughes-reports
[2] http://www.transcanada.com/announcements-article.html?id=2035550&t=
[3] Bloomberg analysts' consensus EPS estimates for Zoetis were US$1.78 for 2016 and US$2.24 for 2017 on March 28, 2016.
[4] Zoetis Company Update, Credit Suisse, March 30, 2016 (p.4).
[5] http://business.financialpost.com/investing/market-moves/snc-lavalin-group-inc-posts-better-than-expected-fourth-quarter-profit

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