CIBC Wood Gundy | Papau Armstrong Schmidt Financial Group

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# Focus on Bank of America and Manulife

The Papau Armstrong Schmidt Financial Group was formed in October of 2014. One of the key reasons for David partnering with Michael and Andrey was to add their discretionary portfolio management skills to the group so that a broader range of discretionary services could be offered to all of his CIBC Wood Gundy clients. We are now pleased to report that we are offering three fully discretionary model portfolios to clients, 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 suit the criteria established for these model portfolios and contribute to their returns. Please review Appendix “A” to this Newsletter for further information regarding these model portfolios.

As we were writing this Newsletter for the second quarter of 2015 (Q2), there were constant media reports regarding various macroeconomic issues, such as further bailouts for Greece, Canadian and U.S. interest rate debates, and the extreme volatility in China’s stock market. These issues have been subject to reversals of fortune on seemingly a daily basis, and we have little to say about them. We are going to devote this Newsletter to significant developments in our model portfolios, all of which are directly linked to client returns.

Bank of America

Bank of America Corp. (NYSE:BAC) is a 7.0% position in our Total Return Portfolio and a 2.0% weighting in our Balanced Portfolio. Before they joined CIBC Wood Gundy, Michael and Andrey began buying the stock for their clients in the Total Return Portfolio back in early October 2012 at US$9.52. At that time, the company appeared to be extremely undervalued, as fears of litigation were running high, as were loan losses.

As of July 17, 2015, the stock was trading above US$18, coming off its best quarterly earnings report in many years. On July 15, 2015, Bank of America announced second quarter revenue of US$22.3 billion, beating all analyst estimates. Legal expenses plunged and net income increased to US$5.32 billion, or US$0.45 a share, also beating analysts’ estimates.[1]

We continue to believe Bank of America shares can provide a good return from these levels over the next several years. We expect the company’s profitability and earnings to continue to improve, and we expect a gradual increase in the dividend. Like all of our U.S. bank holdings, Bank of America continues to experience weak net interest margins, meaning that the spread between the interest that it pays depositors and the interest it charges borrowers is compressed. U.S. interest rate increases would likely help widen net interest margins, raising profitability.

Bank of America's valuation remains relatively low in comparison to certain peers, and the valuation it has received in the past. It appears that many investors are waiting for a consistent run of good earnings reports before re-rating the stock higher.

Manulife Financial

Manulife Financial Corp. (TSX:MFC) is a significant holding in all three model portfolios, with an 8.2% weighting in our Total Return Portfolio, an 8.2% weighting in our High Yield Portfolio and a 3.0% weighting in our Balanced Portfolio as of July 17, 2015. We have purchased Manulife for clients on numerous occasions, beginning in 2009 after we concluded that the company was likely to recover from the financial crisis. We view Manulife as a high-quality business with a long operating history, and we expect to continue to hold its shares. A CIBC analyst recently provided some useful commentary on the company, which we reproduce below in full:

> "CIBC World Markets Inc. (CIBC) analyst Robert Sedran favours owning life insurers over banks given the superior growth profile anticipated from the life insurers over the medium term. Manulife's attractive valuation, its growing Asian platform and its improving risk profile make it his favourite Canadian insurer.
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> At its recent investors' day, Manulife highlighted its wealth management business, which accounts for approximately 40% of its earnings. The company believes that expanding this division will improve margins and boost the company's profitability. Mr. Sedran contends that favourable demographics will enable Manulife to continue the recent trend of volume growth in this business. He notes that revenue growth in wealth management has been strong in recent years, with margin improvement helping to grow its contribution to the bottom line. In Asia, which provides 33% of total earnings, the company expects growth to be driven by: i) a growing middle class; ii) an aging population; iii) increasing household wealth; and iv) digitization – electronic point of sale tools for agents, which Mr. Sedran says have been highly successful since their launch nine months ago. Overall, Manulife has targeted 10%-12% growth in earnings over the medium term, with its wealth management and Asian units being key contributors.
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> Since the financial crisis, Manulife has focused on reducing risk. Its Minimum Continuing Capital and Surplus Requirement ratio, a measure of its risk-adjusted capital relative to its actuarial liabilities, is 245%, which is well above the 150% regulatory requirement and comfortably above crisis-era levels. With its recent 10% dividend increase, strong wealth management business and growing Asian presence, Mr. Sedran believes Manulife is an investment that even light sleepers can be comfortable with in their portfolios over the long term."[2]

We would endorse these comments as being a good summary of the investment case for Manulife.

BP Plc

BP Plc (NYSE:BP) is a 3.3% position in our Total Return Portfolio and a 3.0% position in our High Yield Portfolio. The company recently agreed to pay US$18.7 billion to settle all federal and state claims from the 2010 Deepwater Horizon oil spill. Payments are planned to be spaced out over a number of years. Some estimates of BP's total cost relating to the spill have now risen to US$70 billion, a staggering number for any company.[3]

We are highlighting this news item because it contains useful lessons regarding value investing, contrarian investing and investing in companies facing litigation. Before they joined CIBC Wood Gundy, Michael and Andrey began buying the stock for their clients in the Total Return Portfolio and High Yield Portfolio back in Q1 of 2013 at prices around US$42. By then, the litigation regarding the spill was well underway, and BP's potential liability was estimated to be around US$40-45 billion.

BP remains a holding in both portfolios today. The share price was around US$39 as of July 17, 2015, and clients have made a positive total return on the holding due to the large dividends paid during the hold period, as well as strength in the U.S. dollar. The positive return is quite remarkable given that the legal damages owed by the company exceeded estimates at the time we purchased the stock by approximately 75%, and the price of oil has declined precipitously during the hold period.

One of the benefits of the value or contrarian style of investing we follow is that an investor is theoretically buying a company's shares at a time when a great deal of pessimism about the future is priced in to the share price. If that is the case, negative news will be met with little drama, and positive news will come as a surprise. As U.S. value investor Monish Pabrai is fond of saying, it creates a situation like a coin flip where "heads I win and tails I don't lose too much."

Conclusion

Manulife, Bank of America and BP were all contrarian value opportunities at the time of purchase. Manulife and Bank of America have performed quite well, and look set to receive renewed recognition as high-quality companies that deserve higher valuations than they have received in recent years. BP has experienced a very bad case scenario, yet has provided investors with a total return exceeding the return that has been available on risk-free assets during the hold period. BP should reward patient investors in a scenario where there is a significant recovery in oil prices.

While we are expecting to manage through a number of risks to economic and stock price performance in the coming years, it is likely that we will maintain a position in these companies for quite some time. As always, we thank you for your business and invite you to contact us with any questions.

## APPENDIX "A"

## DISCRETIONARY MODEL PORFOLIOS

We now offer the following three discretionary model portfolios:

1) Our Total Return Portfolio, which 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, which 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, which is a more conservative portfolio that typically consists of approximately 50% fixed income investments and 50% equity investments.

We encourage clients to contact us for more information regarding these portfolios.

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[1] http://www.reuters.com/article/2015/07/15/us-bankofamerica-results-idUSKCN0PP18L20150715?type=companyNews.
[2] CIBC Wood Gundy Investment Strategy Group Monthly World Markets Report – July 2015.
[3] http://www.bloomberg.com/news/articles/2015-07-02/bp-said-to-settle-2010-gulf-oil-spill-claims-with-u-s-states.