Looking for Contrarian Value in Q1

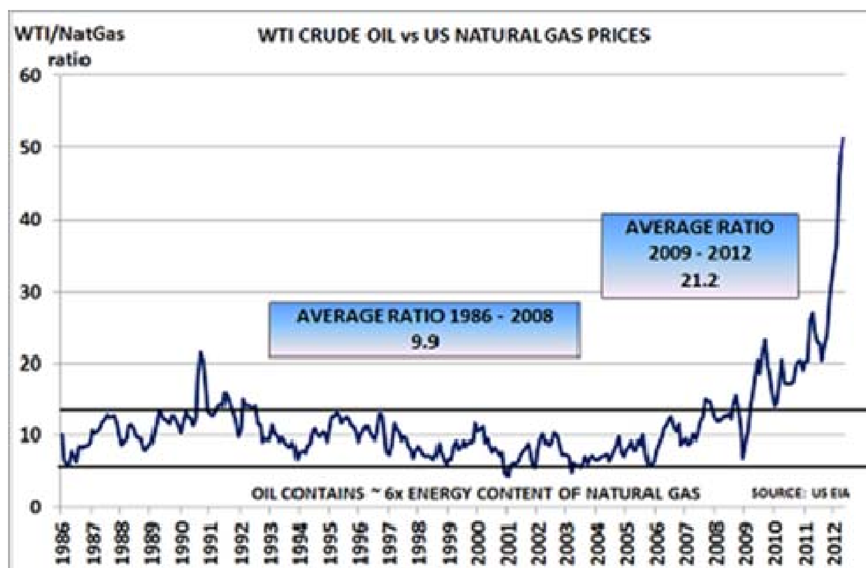
In the first quarter of 2012, which ended on March 31, our Total Return Portfolio returned 4.6%, our High Yield Portfolio returned 2.2% and the TSX Composite Index returned 3.7%.[1] In this edition of the Armstrong Schmidt Perspective, we will discuss some of the changes we have made to the composition of our Total Return Portfolio and High Yield Portfolio. We view many of the changes as contrarian, since we have been purchasing shares in companies that are nowhere near their 52-week highs, and in some cases, are trading at far lower levels than they were several years ago.

Manulife Financial Corp.

On February 14 we added to Manulife Financial at $11.78. Manulife provides insurance and wealth management products and services to individuals and group customers, primarily in Asia, Canada, and the U.S., including life insurance, group life and health insurance, long-term care services, pension products, annuities, mutual funds, and banking products. With the stock well off its 52 week highs and trading at less than 10x 2012 analyst estimates of earnings per share and paying a dividend yield of over 4%, we believe it was a timely purchase.

Encana Corp.

On March 19, we bought Encana at $20.63 in both the Total Return Portfolio and High Yield Portfolio. Encana has great assets, but it has been struggling with the extremely weak pricing environment for natural gas in North America. Over the past quarter century, the price of crude oil has typically hovered around 10 times the price of natural gas in North America. Recently, strong oil prices combined with extremely weak gas prices drove that ratio to an all-time high above 50 times, as shown in the chart below.



There are several reasons for this weakness in natural gas prices. There is a surplus of natural gas in North America at the moment, and the current level of liquefied natural gas export infrastructure is inadequate to ship meaningful quantities elsewhere. This is unfortunate, as natural gas pricing is currently much stronger in Asia and Europe than it is in North America.

Buying Encana is definitely a contrarian bet. The consensus outlook for natural gas pricing is bleak. Interestingly, we owned Encana in the past but sold in May of 2011 at $31.97 when it seemed likely that the natural gas market would weaken due to excess supply. Now, roughly a year later and 35% below where we sold the stock, we see good value in the company again.

Encana has taken steps to protect itself from the weak pricing environment. As of December 31, 2011, the company had hedged about 65% of its expected 2012 natural gas production with fixed price contracts at an average price of US$5.80 per thousand cubic feet (mcf). Additionally, Encana has hedged about 15% of its expected 2013 natural gas production at an average price of US$5.24 per mcf. These risk-management measures have helped, as current prices are around US$2 per mcf.[2] The company is also responding to the current pricing by reducing its dry natural gas development expenditures and spending more on oil and

liquids-rich natural gas drilling. Encana has also entered into a couple noteworthy transactions in the past year that have reminded us of the value of some of its assets. For example, in mid-April, a Japanese company committed $602 million to a joint venture with Encana regarding certain coalbed methane assets in Alberta that we do not even see as essential to Encana's future growth.[3]

We do not expect an imminent rebound in natural gas prices, but looking out three to five years, it seems likely that prices will improve substantially. Electric utilities have already started burning more natural gas and less coal. LNG export capacity is likely to grow substantially. (Encana owns 30% of the Kitimat, British Columbia LNG export project, which could begin operations in a few years.) The use of natural gas in trucking is also growing. For example, the delivery company UPS has already converted 59 of its long-haul trucks in California and Nevada to natural gas. Wal-Mart is also testing the use of natural gas in its California trucking fleet.[4] Also, the number of rigs drilling for natural gas in the U.S. hit a 10 year low recently, which could help curtail supply.[5]

It is possible that we are making this investment in Encana too early in this difficult natural gas cycle. That said, we have already avoided some of the downside in the stock by selling in 2011 as discussed earlier. There is also some appeal to collecting the company's 4% dividend yield while we wait for natural gas pricing to improve.

Exelon Corp.

On January 12, we added to our position in Exelon Corp. at $40.16 in both the Total Return Portfolio and the High Yield Portfolio. Exelon has become the largest electrical utility in the United States after its recent merger with Constellation Energy. We are looking past the recent weakness in the stock, as we are focused on the company's long-term fundamentals. In 2012, Exelon's earnings will be depressed by low power prices. Power prices are low because natural gas prices are extremely low (a lot of electricity is generated by burning natural gas) and the U.S. economy is still relatively weak, reducing industrial power demand.

By late 2013, we think the company will start to show major upside. It is a low cost producer of electricity with its massive nuclear fleet, which should translate into strong earnings when power prices improve. A significant portion of Exelon's business consists of regulated utility operations, providing some stability

while shareholders wait for improvement. It is also currently paying a dividend of US$2.10 per year, which is a 5.5% yield at these prices.

Staples Inc.

On January 24, we bought Staples Inc. at $16.04 in both the Total Return Portfolio and the High Yield Portfolio. Staples is the world's largest office products retailer. The company's retail stores are a familiar sight, but most people do not know that Staples is second in the world in e-commerce sales (behind Amazon) due to its numerous corporate customers that order supplies online for delivery. We like the company's online presence and its industry dominance.

We think the company is undervalued and offers good total return potential over the next few years. The company earned US$1.37 per share in 2011, meaning we paid only 11.7 times last year's earnings. Earnings and dividends are growing. Management guidance is for high single-digit earnings per share growth and low single-digit sales growth for 2012 in comparison to 2011. The company also repurchased over US$600 million of stock in 2011 alone, which is a significant amount in relation to its US$11 billion market capitalization.[6] We believe the company is well-managed and shareholder-friendly, which adds to its appeal.

Canaccord Financial Inc.

On February 14, we bought Canaccord Financial at $9.10 in both the Total Return Portfolio and the High Yield Portfolio. Canaccord's competes in both wealth management and investment banking. The investment banking side of its business has been weak over the past year, driving down the stock price. Canaccord is a leading investment bank in Canada for small-cap, growth-oriented natural resource companies.

At the risk of oversimplification, when the TSX Venture Exchange is doing poorly, as it has been, it is more difficult for Canaccord's investment banking clients to raise money, and Canaccord earns less as a result. These difficulties are cyclical, and we believe that when the cycle turns, there could be substantial upside in Canaccord's stock price. While we wait for the small cap resource investment banking cycle to turn, the company is paying us a dividend of 4.7%.

Cenovus Energy Inc.

On February 14, we sold 42% of our position in Cenovus Energy at $38.49. The company remains a substantial 4.5% holding in our Total Return Portfolio after the transaction. We are very positive on Cenovus for the long term, but we decided to trim the position into strength, as the stock had risen strongly since December 2011.

Other Transactions

In the High Yield Portfolio only, it is worth mentioning that we sold out of corporate bonds of Canadian Tire Corp. Ltd. and Fairfax Financial Holdings Ltd. on the basis that they had risen in value since purchase and become overvalued in our view. Over the last 2 years, specifically, the prices of many fixed-income assets have risen strongly as a result of continued easy monetary policy.

Conclusion

A potential downside of some of the out of favour stocks we purchased in Q1 is that we may be early, and there could be more downside in the short to medium term. We are content to take on that risk, since we see each of these new investments as undervalued relative to the long-term prospects of their underlying businesses.

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[1] All return numbers discussed are taken from the returns of the model account for each respective discretionary PIMG portfolio. These numbers are generated using Dataphile software and individual client's account performance may vary. These numbers are not a promise of future performance.
[2] *Encana Management Discusses Q4 2011 Results - Earnings Call Transcript*, http://seekingalpha.com/article/375961-encana-management-discusses-q4-2011-results-earnings-call-transcript (April 13, 2012).
[3] Dina O'Meara, *Encana sells Horseshoe Canyon stake to Toyota Tsusho for $602 million*, http://www.calgaryherald.com/business/energy-resources/6492821/story.html (April 28, 2012)
[4] Kim Souza, *Trucking Industry Mulls Natural Gas Conversion*, http://www.thecitywire.com/node/20121 (April 13, 2012).
[5] Reuters, *Natgas drilling rig count hits new 10-year low*, http://www.reuters.com/article/2012/04/27/us-energy-natgas-rigs-idUSBRE83Q12020120427 (April 28, 2012).
[6] Staples, Inc. Earnings Webcast, Fourth Quarter 2011 Presentation dated February 29, 2012.

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