Q1 Highlights Include New Positions in Abbott Labs and Unilever

It has been a good start to 2014 for our two discretionary portfolios - the Total Return Portfolio and the High Yield Portfolio. They gained 4.22% and 4.12%, respectively, for the quarter ended March 31 (Q1).[1] Having taken a broad perspective in our 2013 year-end newsletter, we are going to devote this Q1 edition of the Armstrong Schmidt Perspective to specific matters affecting the portfolios.

Energy Sector

Canadian Natural Resources Ltd. (TSX:CNQ), a multi-year holding, was a standout performer during Q1 for the Total Return Portfolio. The company's shares rose from $35.94 to $42.37 during the quarter, giving shareholders a gain of 18% not including dividends. Part of the gain can be attributed to a gain in the price of oil during the quarter. In addition, some investors must have recognized that the company's shares have been trading at undervalued levels.

Canadian Natural has a strong future production growth profile. In addition, the company recently announced a 13% increase in its quarterly dividend to $0.225 per share. This increase follows a more significant 60% increase to the dividend in November, 2013. Canadian Natural continues to be a significant holding in our Total Return Portfolio, with a weighting of 7.6%.

Healthcare Sector

There is a limited supply of publicly-traded high-quality Canadian healthcare companies. We often find ourselves researching companies located south of the border in this sector. Johnson & Johnson (NYSE:JNJ) is a good example of a high-quality healthcare company with a long track record of good business performance. It has been a multi-year holding for us in our High Yield Portfolio, and we are pleased with its performance.

On February 5, we added a 3% weighting in Abbott Labs (NYSE:ABT) to the Total Return Portfolio at a price of US$36.52 per share. Like J&J, Abbott is a large, diversified healthcare company with a long track record of good business performance. Abbott's products include medical devices, nutritional supplements, diagnostic equipment and generic pharmaceuticals. Approximately 30 percent of the company's sales are in the United

States, 30 percent of sales are in other developed markets such as Canada, Western Europe, Japan and Australia, and 40 percent are in emerging markets, particularly in India, China, Russia and Brazil. The emerging markets exposure may be a modest near-term negative, but we believe it will give Abbott higher growth potential over the long term.

Abbott's dividend yield is around 2.3% at recent share prices. The company has increased its dividend for 41 consecutive years. We would not claim that the company's shares were massively undervalued at our purchase price, but we are content with making an investment in such a high-quality business, likely for a multi-year hold period.

Consumer Staples Sector

On December 11, 2013, we added a 2.5% weighting in Unilever PLC ADS (NYSE:UL) to the Total Return Portfolio and a 3% weighting to the High Yield Portfolio at a price of US$40 per share. While this was a Q4 2013 transaction, we will discuss it briefly, as it fits nicely in this Q1 edition.

Unilever is a high-quality business with immense global reach. Its products include ubiquitous brands like Dove soaps and Lipton teas, and it sells into more than 190 countries. Unilever shares rose only slightly during 2013, despite the strong performance of stocks generally. One reason for its short-term underperformance has been the company's emerging-market exposure, which is significant. For example, the company states in its investor materials that it has more than 50 years of experience in Brazil, China, India and Indonesia. Many emerging economies have experienced slower than expected growth as well as currency weakness over the past 18 months. We are well aware of the challenges, but as with Abbott Laboratories, we believe Unilever's emerging-market exposure will give it higher growth potential over the long term.

Another commonality between Abbott and Unilever is that both companies possess multiple defensible streams of earnings. They both sell a range of products, and the types of products they sell are not very cyclical. Customer demand should remain solid despite economic fluctuations. We mentioned Abbott's dividend track record; Unilever also boasts an impressive record, as they have grown their dividend at a compound annual growth rate of approximately 8% from 1979 to today.

Consumer Discretionary Sector

During Q1 we were sellers of some of our consumer discretionary sector investments. On February 18, we sold just over one third of our Total Return Portfolio position in sale of MGM Resorts International

(NYSE:MGM) at US$25.96. The sale netted us a gain of over 100% on our January 2013 purchase price of US$12.60. The Total Return Portfolio's remaining weighting in MGM is around 2.3%. On March 7, we sold Staples Inc. (NASDAQ:SPLS) out of the Total Return Portfolio and High Yield Portfolio at US$11.47 per share. This investment resulted in a significant loss of around 16%, despite the dividends received during the two year hold period.

We are firm believers in the value of analyzing our mistakes. Our key mistake with this investment was over-estimating the company's future earnings potential at the time of purchase. Even though the company maintained a strong online presence during our hold period, the results at its big box stores were weaker than we had expected. This impacted the top line, as the company's annual revenues declined for the past two years, as well as the bottom line, as the company posted quarterly losses at various times during our hold period. Staples can be characterized as fairly well-managed and shareholder friendly, but the poor industry fundamentals have outweighed the company's efforts in recent years.

We could envision a scenario from today in which Staples successfully turns around as a business, but we have decided to move on to better ideas. As a prominent U.S. hedge fund manager once said,

> "If we decide we were wrong about something, in terms of why we did it, we exit, period. We never invent new reasons to continue with a position when the original reasons are no longer available." – *David Einhorn, Greenlight Capital*

There were two other sales of consumer discretionary positions worth mentioning. Our January 13 sale of Michael Kors Holdings Ltd. (NYSE:KORS) out of the Total Return Portfolio at US$77.94. Our gain of approximately 43% in this position in just 211 days can be attributed to buying a very profitable fast-growing business at a moderately undervalued price.

Finally, our December 2013 sale of Whistler Blackcomb Holdings Inc. (TSX:WB) out of the High Yield Portfolio at $16.48 resulted in a return of 89.3% in just over two years when including the substantial dividend.

<u>Technology Sector</u>

Our March 4 purchase of Points International (TSX: PTS; NASDAQ: PCOM) at US$29.39 represents an interesting small addition to the Total Return Portfolio. Points International has created a form of online exchange for loyalty and reward points collected by customers of various businesses. Members of rewards programs can buy, gift or transfer points through the company's website. The company has partnered with numerous significant airlines, retailers and hotel chains.

On February 18, the company announced that it had added credit card giant Mastercard Inc. as a partner. We like Points International's business model, as it appears to be scalable and asset-light. We believe the company may be establishing a strong competitive position by signing up major brands as partners. We expect strong revenue growth from the company over the next 3 years. There is no doubt that Points International is riskier than our typical portfolio company, but it also has strong upside potential with its small market capitalization of approximately US$400 million. Points International has a small weighting of just under 2% in the Total Return Portfolio.

Other Notable Transactions

In early March, we sold the last remaining portion of a multi-year holding in Silver Wheaton Corp. (TSX:SLW) out of the Total Return Portfolio at $28.18, resulting in a solid gain. In the same portfolio, we sold Canfor Pulp Products Inc. in early January at $10.96, resulting in a gain of 11.6%, including dividends. In the High Yield Portfolio, other notable transactions include the sale of Thomson Reuters Corp. (TSX:TRI) for a solid gain of 36.9%, and the sale of Canaccord Genuity Group Inc. (TSX:CF) at a loss of 3%, in both cases including dividends. We also purchased a small position in Annaly Capital Management Inc. (NYSE:NLY) at US$10.23.

Conclusion

We are pleased that returns in Q1 have been positive, but a single quarter's results will not determine the quality of our year. There are some challenges to overcome during the remainder of 2014, including the ongoing crisis in Ukraine. Also, many companies now trade at higher valuations than they did over the past couple years. This shrinks our universe of potential new investments, as we must always weigh risks against potential rewards. We will continue to be very selective and focus on companies that provide us with the desired combination of high quality businesses and undervalued share prices.

As always, we thank you for your business, and invite you to contact us with any questions or comments.

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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.