Adding to U.S. Financials Again

It has been a good start to 2013 for both the Total Return Portfolio and High Yield Portfolio, which have gained 10.02% and 14.47% respectively as of July 31, 2013.[1] Broad themes include the out-performance of US stocks relative to Canadian stocks, strong performance from financial sector stocks, and weak performance from materials sector stocks, especially miners. In the second quarter of 2013 (Q2), we made several interesting adjustments to the portfolios. The financial sector is a good starting point, as it is heavily weighted in both portfolios and has been a major positive contributor to portfolio returns.

Financials

Our aggregate weighting in the financial sector continues to hover around 25% in the Total Return Portfolio and 20% in the High Yield Portfolio.

On June 28, we added to our existing position in Berkshire Hathaway Inc. (NYSE:BRK.B) for the Total Return Portfolio at US$112.39. 5.1% of the Total Return Portfolio is now invested in Berkshire. This high-quality mega-capitalization company is classified as a "financial", as its most important business is insurance, but it also owns other massive assets such as the Burlington Northern Santa Fe railroad and utility company MidAmerican Energy.

We started buying the stock at US$72.15 in early October of 2011. That now appears to be an excellent entry price with the stock quoted recently around US$116, but ideally we would have purchased a heavier weighting. Looking forward, we expect Berkshire shares to provide moderate upside if the U.S. economy continues to recover and only moderate downside risk if it weakens. While we hold the shares, we expect the company to continue its long track record of excellent capital allocation. It tends to acquire more operating companies and promising passive investments every year.

On May 6, we added to our Total Return Portfolio position in Bank of America Corp. (NYSE:BAC) at US$12.76. 5.5% of the portfolio is now invested in the company. We discuss the company in depth in our Q4 2012 Newsletter, which is archived on our website, as we had purchased shares at US$9.52 in early October of that year. Since our thesis that the company is turning around is starting to be proven correct, we decided to add to the position.

On July 17, 2013, the bank reported its second quarter 2013 results. Earnings per diluted share increased to US$0.32 from US$0.19 in the second quarter of 2012. Revenue rose 3 percent to US$22.9 billion from US$22.2 billion a year ago.[2] Analysts' consensus earnings estimates for 2013 are US$0.90 per share. Despite recent strong gains, Bank of America shares continue to trade far below book value of US$20.18. As we said in Q4 2012, in a few years we could potentially see this company earning well over US$1 per share and trading near book value. Patient investors should be well rewarded.

On May 6, we purchased Citigroup Inc. (NYSE:C) at US$47.76, giving the company a weighting of 2.0% in the Total Return Portfolio. Analysts' consensus estimates for 2013 earnings per share are US$4.89, meaning the company had a forward PE of less than 10 times our purchase price. Book value per share is US$63.02.[3]

Like Bank of America, Citigroup was left with billions of troubled assets after the global financial crisis. In recent quarters, Citigroup has held the bulk of these troubled assets in a division called "Citi Holdings". As of June 30, Citi Holdings' assets had declined 31% from the prior year period and represented only 7% of total Citigroup assets, a manageable figure.

Perhaps the most appealing feature of Citigroup is its massive international banking franchise, as it does business in more than 150 countries around the world. This international network, which took many decades to create, gives the company the ability to allocate capital to the most attractive economies. We believe the recovery in the bank's results has been underway for a while, its valuation at our purchase price is too low, and earnings should be strong in the next couple of years.

On May 6, we sold US regional bank Synovus Financial Corp. (NYSE:SNV) out of the Total Return Portfolio at US$2.73, giving us a modest gain of approximately 14% including dividends over our multi-year holding period. Synovus represented our initial foray into distressed US financial institutions after the global financial crisis. We purchased the stock back in Q2 of 2010 when it was generating quarterly losses, anticipating a return to profitability over a multi-year time frame. Our thesis on the business has largely proven correct, as the bank has returned to profitability, but the timing of our purchase was too early, as the stock declined significantly after we bought. Now that it has recovered, we are moving on simply because we have identified better quality, higher probability opportunities in the financial sector.

On April 10, we sold commercial real estate services firm CBRE Group Inc. (NYSE:CBG) out of the Total Return Portfolio at US$24.98, giving us a gain of approximately 46% including dividends over our short holding period. In this situation, we benefited from purchasing the stock at undervalued levels, followed by

a better than expected quarterly earnings report that drove the shares higher. The company's business continues to perform well, but we decided to realize the gain and move on.

On July 2, we sold part of our position in Canaccord Financial Inc. (TSX:CF) at $5.63. This represented a gain from our most recent purchase in late 2012 at $5.14 but a loss from our $7.12 average cost. Our original thesis for buying the shares was that the company's investment banking business would experience a strong medium-term cyclical rebound, but that now seems less likely with various commodities prices dropping. We continue to hold a 2.2% Total Return Portfolio weighting in the stock and we will be monitoring the company's progress in turning its business around.

On April 23, we purchased a 3.3% weighting in the High Yield Portfolio in shares of Bank of Nova Scotia (TSX:BNS) at $56.99. We like the bank's solid track record and growing international business. With a dividend yield over 4% and a track record of increasing dividends over time, it suits the mandate of the High Yield Portfolio.

Consumer Discretionary

On June 14, we bought shares of Michael Kors Holdings Ltd. (NYSE:KORS) at US$58, giving it a weighting of 1.5% in our Total Return Portfolio. Michael Kors is a fast-growing and extremely profitable designer and retailer women's apparel and accessories, such as handbags, for the luxury and accessible luxury market.

Although this is a small portfolio position, we are especially interested in the outcome. We typically purchase high-quality companies that we believe are undervalued, most of which have long track records and mature businesses. We can easily argue for their undervaluation using standard financial ratios and statistics. That is a good method, and it works, but we also want to improve our ability to identify fast growing companies that may not on the surface appear to be statistically undervalued, but will in fact justify their valuation and rise substantially. In the past we have sometimes avoided that type of company due to moderate statistical overvaluation, only to realize two years later that its growth more than justified its valuation.

Michael Kors has certainly been growing rapidly, and the stock price is not cheap. In late May, the company reported its 2013 fiscal year results. Compared to the US$0.78 per share the company earned in its 2012 fiscal year, it earned US$1.97 per share in fiscal 2013 and guided towards a range of US$2.43-$2.47 for its fiscal 2014 (April 1, 2013 to March 31, 2014). Other highlights include annual revenue growth of 67.5% and comparable store sales growth of 40.1%.

We expect the company's growth rate to slow down over time, but we think it can grow its earnings at a 15-25% compounded rate for the next several years. The company has plenty of room to increase its store count and also grow its online sales. We also take some comfort in the fact that many of our affluent female clients between the ages of 30 and 45 love the company's products.

We paid approximately 24 times 2014 estimated earnings for the company's shares, which is a high valuation. There is clearly a significant risk that the company's growth fails to meet expectations, leading to a far lower valuation. We think there is a higher probability that the company's high growth and profitability give us a significant return on the position. Whatever the outcome, we are making a concerted effort to expand our analytical abilities regarding fast-growing companies such as Michael Kors.

On June 26, we sold our position in Wynn Resorts Ltd. (NYSE:WYNN) at US$128.03 for a gain of 13.9% including dividends. In the Las Vegas and Macau casino industry we continue to hold MGM Resorts International (NYSE:MGM) as a turnaround investment. MGM reported a surprise profit for its first quarter of 2013, and the shares are up substantially from our US$12.60 purchase price in January.

Energy

National Oilwell Varco Inc. (NYSE:NOV) is a worldwide leader in the design and manufacture of oil and gas drilling equipment with a market capitalization of US$30 billion. We purchased shares of the company on May 23 at a price of US$68.84. We decided to buy because of the company's strong competitive position in its industry, its high profitability, its current low valuation and its proven ability to grow and to successfully integrate acquisitions.

Analysts' consensus estimates for 2013 are for US$5.63 of earnings per share. At our purchase price, the stock was trading at a price to earnings ratio of 12.2 times those estimated earnings. The company recently announced that its backlog for capital equipment orders for its rig technology segment was at a historic record level of US$13.95 billion as of June 30, 2013, up eight percent from the end of the first quarter of 2013 and up 24 percent from the end of the second quarter of 2012.[4] We believe that National Oilwell Varco has a bright future, as the trends towards exploring for oil offshore and in tight unconventional rock formations will likely lead to strong demand for the drilling equipment manufactured by the company.

In the Total Return Portfolio, on June 5, we sold half of our position in Canadian Oil Sands Ltd. (TSX:COS) at $19.97. On June 26, we sold the remainder at $19.27. These sales resulted in a capital loss, yet the dividends received over the holding period for longer-term clients resulted in a modestly positive total return. The company continues to own an extremely large oil sands resource with a long lifespan and

continues to pay a sizeable dividend. That said, we were disappointed with the company's inability to generate meaningful production growth, and its capital expenditure requirements frequently were larger than we anticipated. In comparison, other portfolio holdings Canadian Natural Resources Ltd. (TSX:CNQ) and Cenovus Energy Inc. (TSX:CVE) have proven their ability to consistently grow production. Those companies remain in the Total Return Portfolio.

On May 9, we sold Calfrac Well Services Ltd. (TSX:CFW) at $27.81 generating a modest profit of 9% including dividends during a hold period of just over one year in the Total Return Portfolio.

Utilities

On June 24, in the Total Return Portfolio, we sold our position in Exelon Corp. (NYSE:EXC) at US$30.51, resulting in a negative return of approximately 14% during the multi-year hold period, including dividends. We originally purchased the shares with the thesis in mind that U.S. electricity prices would rise and the company's earnings were only temporarily depressed. In fact, natural gas prices remained quite low longer than we had expected, depressing electricity prices, and the company's earnings have been consistently disappointing. While we have moved on from the stock in the Total Return Portfolio, we are maintaining a position in the High Yield Portfolio, as it is an above average yield investment.

Industrials

Terex Corporation (NYSE:TEX) is a manufacturer of industrial equipment including aerial work platforms and cranes. On April 5, we bought shares of Terex at US$30.85, believing that the business was improving and the valuation was low. Not long after, on May 22, we sold Terex at US$35.59, realizing a gain of approximately 16% (which includes some currency exchange benefit). Terex's business results and its shares can be quite volatile. On June 17, Terex announced that it was lowering its full year earnings guidance. We may be interested in repurchasing the shares at the right price.

Manitowoc Co. (NYSE:MTW) is a manufacturer of cranes and foodservice equipment. We discussed the company in detail in our Q1 newsletter. We had purchased Manitowoc shares on January 16 at US$16.08. On June 12, we sold Manitowoc at US$19.11, giving us a gain of approximately 22% (which includes some currency exchange benefit). We continue to like the company, and may be interesting in repurchasing the shares at the right price.

We consider Terex and Manitowoc to be good businesses but also very cyclical, and we do not believe that they should be bought and held indefinitely. We did not initially plan to buy and sell them so rapidly, but we were presented with the opportunity to make strong short-term returns by the market.

Our strategy with General Electric Co. (NYSE:GE) has been far different. It is interesting to go back to our Q4 2011 Newsletter, which is archived on our website, and review our thoughts on GE. We bought the stock in late December 2011 at US$17.60 and labeled it a "turnaround story". Recently, GE shares have traded around US$24.50, supported by a strong backlog of customer orders. The company has also increased its dividend significantly during our hold period. Like Terex and Manitowoc, GE is classified as an "industrial" company, but its massive size and diverse array of products reduce the volatility of its results. We continue to hold the stock. On May 14 we sold Richie Bros. Auctioneers at $20.60, generating a profit of approximately 17% including dividends during our nearly 2 year hold period in the Total Return Portfolio.

Conclusion

With Q2 completed, and Q3 off to a positive start, we are optimistic that we can produce strong returns for clients in 2013. 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.

2 Bank of America Q2 Earnings Press Release dated July 17, 2013.

3 Citigroup Q2 Earnings Press Release dated July 15, 2013.

4 National Oilwell Varco Q2 Earnings Press Release dated July 30, 2013.

Michael Armstrong and Andrey Schmidt are Investment Advisors with CIBC Wood Gundy in Vancouver. Their clients may own securities mentioned in this column. The views of Michael Armstrong and Andrey Schmidt do not necessarily reflect those of CIBC World Markets Inc. CIBC Wood Gundy is a division of CIBC World Markets Inc., a subsidiary of CIBC and a Member of the Canadian Investor Protection Fund and Investment Industry Regulatory Organization of Canada. This information, including any opinion, is based on various sources believed to be reliable, but its accuracy cannot be guaranteed and is subject to change. CIBC and CIBC World Markets Inc., their affiliates, directors, officers and employees may buy, sell, or hold a position in securities of a company mentioned herein, its affiliates or subsidiaries, and may also perform financial advisory services, investment banking or other services for, or have lending or other credit relationships with the same. CIBC World Markets Inc. and its representatives will receive sales commissions and/or a spread between bid and ask prices if you purchase, sell or hold the securities referred to above. © CIBC World Markets Inc. 2015