CIBC Wood Gundy

Adding to Select US-Traded Stocks

It has been a solid first half of 2014 for both the Total Return Portfolio and the High Yield Portfolio, despite mixed economic data and the headwind of some international geopolitical conflict. In the second quarter of 2014, we continued to manage the portfolios with a steady hand. There are only a few transactions to discuss in this edition of the Armstrong Schmidt Perspective, as we are generally content with the current holdings in both portfolios.

Toyota Motor

On June 17, we purchased shares of automaker Toyota Motor Corp. (NYSE:TM) for the Total Return Portfolio at US$114.76, giving the company a portfolio weighting of 2.5%. From a valuation perspective, our reasoning is straightforward. We expect the company to earn around US$12-13 per share in its 2015 fiscal year ending March 31, 2015, giving the company a forward price to earnings ratio under 10. There are few high quality companies in today's market trading at such a low multiple, and fewer still with Toyota's revenue and earnings growth potential. We expect the company to continue to return capital to shareholders. Toyota shares pay a dividend yield above 2% at current prices, and there is some potential for share buybacks, although none have taken place in recent years.

Toyota's business prospects require a detailed review. We view the company as a high quality business that has overcome some challenges in recent years. The financial crisis of 2008-2009 caused significant sales declines in key markets. 2008 was the first year in recent history in which the company lost money. The company has operated profitably more recently, but has faced new challenges. In 2009 and 2010, Toyota recalled millions of vehicles due to a safety concern about unintended acceleration. Because the company's prior track record for quality was so high, the recall was a significant short-term blow to its reputation. Then, in 2011, Japan's earthquake and tsunami severely curtailed the company's vehicle production, impacting results.

Despite these challenges, in 2013, Toyota once again ranked first globally in auto sales:

"The Japanese firm posted sales of 9.98 million [vehicles], narrowly missing out on becoming the first automaker ever to break the 10 million mark but staying ahead of GM at 9.71 million and VW at 9.7 million.

Barring 2011, …Toyota has been number one every year since 2008, when it usurped long-time leader GM. Toyota said in a statement it aims to break the 10-million mark in 2014.” [1]

Toyota’s manufacturing process is widely regarded as the best in the industry. Also, the company’s large investment in hybrid technology has been validated, as the Prius and other hybrids now represent over 10% of the company’s sales. Toyota’s luxury brand, Lexus, continues to be rated highly across the board by customers and market research firms. For example, Lexus recently earned the top overall score in the Consumer Reports’ Car Brand Report Cards for the second consecutive year.[2]

The company also continues to innovate:

“Toyota introduced its fuel-cell vehicle, the FCV, in Japan recently…. It will go on sale in Japan by next April, with a launch in the U.S. and Europe by the summer 2015. The sedan will cost the equivalent of about $69,000 in Japan, but U.S. and European prices haven’t been decided yet… A fully fueled FCV can... drive about 300 miles without refueling... The new sedan will get to 60 mph in about 10 seconds... Toyota has been developing the technology in house for more than 20 years. In 2002, the company leased the FCHV, a fuel cell SUV, in Japan and the U.S. on a limited basis…. Toyota says that big improvements have been made since then. Performance now rivals gasoline engines, according to the company, and refueling takes about three minutes.”[3]

Despite the attractive features of the company’s business, our anticipated time horizon for holding Toyota shares is perhaps somewhat shorter than our typical 3-5 years. The auto industry moves in cycles along with the economy, and while today may be a decent time in the cycle to invest, that macro outlook can change. Also, Toyota is not currently a distressed company, so waiting for a turnaround is not really required. Its business is already improving, and we hope to benefit from that trend in the near term.

Disruptive technological change impacting the auto industry is another reason why we cannot commit to a long hold period for Toyota shares. Many young urban adults are turning to car sharing as a more affordable option than private car ownership. Also, Google Inc. is advancing self-driving cars. Some of Google’s initial prototypes were actually retrofitted Toyota vehicles, but more recent models have been Google’s own vehicles. Some urban planners are now contemplating a future with zero individually-owned cars.[4]

A future with fewer privately-owned cars is certainly possible, but definitely not immediate. In the next couple of years, Toyota looks to us like a high quality business with an undemanding stock valuation, giving us good return potential.

Wells Fargo

On April 17, we purchased shares of U.S. bank Wells Fargo & Co. (NYSE:WFC) for the High Yield Portfolio at US$49.15, giving the company a portfolio weighting of 3%. Many clients will be familiar with this company, as we purchased Wells Fargo shares for the Total Return Portfolio on November 30th, 2012 at US$33.

Wells Fargo is currently the largest residential mortgage lender in the U.S., and it has the highest stock market capitalization of any U.S. bank at around US$270 billion. The majority of its business consists of traditional banking operations such as taking deposits and making mortgage loans, auto loans, and issuing credit cards. Looking at the bank's recent results, we are seeing gradual loan growth, and asset quality appears to be high. There is ample evidence that the bank is well-managed and shareholder-friendly. Wells Fargo continues to return a significant amount of capital to shareholders through dividend increases and share buybacks. The current dividend yield is approaching 3%.

Analysts' expectations are for US$4.10 in EPS for 2014, which would represent 5.4% growth over 2013's EPS of US$3.89. That level of growth may not be exceptional, but the bank has good multi-year growth potential if its net interest margin starts to expand. Net interest margin measures the spread between what a bank makes on its loans and what it pays on deposits. In the second quarter of 2014, net interest margin decreased to 3.15%. If interest rates rise as projected over the next couple of years, net interest margin could expand, helping EPS growth. As a high quality company with a solid dividend, Wells Fargo is a suitable holding for the High Yield Portfolio.

General Electric

On April 17, we added to our position in General Electric Co. (NYSE:GE) in the Total Return Portfolio at US$26.69. The company now makes up 5.6% of the portfolio. Our initial purchase of GE took place in late December of 2011 at US$17.60, when the company was still in somewhat of a distressed situation. Results have improved since then, and we continue to like the company's strategic direction. Management is moving the company back towards its historical roots as an industrial company and away from finance activities.

Recent news includes GE's offer to purchase the power equipment business of France's Alstom SA for around US$17 billion. The transaction is targeted to close in 2015 and is expected to be accretive to GE's 2015 and 2016 earnings. The transaction will help GE move towards its goal of achieving 75% of earnings from its industrial businesses by 2016. GE is also planning the IPO of its North American retail finance business Synchrony Financial in late July and a sale of its low-margin home appliance business in the near term. We view all of these transactions positively. In 2011 we viewed GE as a turnaround investment, but at this point, it has successfully re-established itself as a high-quality large-cap industrial company that offers earnings growth potential and a dividend yield over 3%.

Conclusion

Under our philosophy, the level of activity in client portfolios is driven by opportunity. At the moment, we are generally content to continue to hold our current investments, rather than make wholesale changes, as we believe there is upside in simply staying the course. Our best ideas are companies that we already own.

With the first half of 2014 completed, we are optimistic that we can produce strong returns for clients in 2014. As always, we thank you for your business, and invite you to contact us with any questions or comments.

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1 http://www.telegraph.co.uk/motoring/car-manufacturers/toyota/10594637/Toyota-still-the-worlds-biggest-car-manufacturer.html

2 http://www.nytimes.com/2014/02/26/automobiles/lexus-ranked-no-1-on-consumer-reports-annual-brand-report-cards.html?_r=1

3 http://www.marketwatch.com/story/toyota-reveals-fuel-cell-vehicle-sedan-2014-07-23

4 http://www.entrepreneur.com/article/235646