Have Blue Chips Become too Boring for Impatient Investors?

The cornerstone of our investment philosophy is buying undervalued high quality companies with good track records, and it is important to us that our clients (and prospective clients) understand our philosophy. Simply finding high quality companies is not enough. Ideally we will be paying far less than the shares are worth. The undervalued high quality companies we found through our research process in the fourth quarter of 2011 (Q4) all embody the same proposition – a high probability of strong returns over a 3-5 year period paired with an acceptable level of downside risk.

In this edition of the Armstrong Schmidt Perspective we are going to examine the practical application of our philosophy in Q4. Despite the continuation of the many macroeconomic headwinds that we have discussed in past editions, in Q4 we found opportunities in several undervalued high quality stocks that we could not pass up. Our intent in this edition is to give readers some specific examples of how we choose individual stocks.

Our new purchases reduced our allocation to cash in our Total Return Portfolio from a defensive 25% at the end of Q3 to approximately 8% at year's end.

We are very excited about the prospects for our holdings in the Total Return and the High Yield Portfolios. 2011 was a difficult year for Canadian investors, with both the S&P TSX Composite Index and our Total Return Portfolio dropping approximately 11% and our High Yield Portfolio gaining approximately 1%. 2012 has a chance to be much better, as we have started the year with strong gains. In fact, the Total Return Portfolio is up roughly 8% in January 2012.[1]

Some Great Companies are Being Neglected

When a company's shares stay flat for years, impatient investors may sell in order to chase performance elsewhere. This often ends badly for these "momentum" players. After they move on, the neglected company gets more and more undervalued.

We think it is unfair to call great large capitalization companies like PepsiCo Inc. and Berkshire Hathaway Inc. boring, but clearly investors have not been enthused about these companies recently. Many blue chips of this nature are trading near their lowest valuations in the past 15 years. There are various explanations.

In the late 1990s, most stocks were incredibly overvalued. Everyone knows about the technology boom and bust, but the "irrational exuberance" also extended to blue chip stocks, which often sold at valuations over 30 times earnings per share (EPS). People believed that these companies' consistent results and entrenched competitive positions justified the high valuations. But no matter how great a business is, investors who buy and hold overvalued stocks for the long term are bound to underperform, as performance tends to eventually revert to the long-term mean.

Inevitably the recession of the early 2000s arrived, ending the euphoria, and recent years have seen more than their share of macroeconomic turmoil. The shares of many blue chips have stagnated for a decade, even as they have consistently improved their financial results and grown the value of their businesses.

The share price stagnation is actually great news for today's buyers of these stocks. Today's buyer should care about the risk vs. reward calculation for the next five years, not look in the rear view mirror. When a company's stock stays flat for a few years while its financial position consistently improves, the company's valuation slowly compresses like a coiled spring. The market is focused on the admittedly poor current macroeconomic environment and the weak returns of these stocks over the past decade while ignoring the attractive future risk vs. reward proposition.

This reasoning applies to our purchase of **Berkshire Hathaway Inc.** at $72.15 in early October for the Total Return Portfolio. Berkshire traded around those same levels as far back as late 2006. The two year chart below shows more recent trading action. Berkshire's year-end book value per share for 2006 was $46.88[2] whereas we expect year end 2011 book value per share to be close to $70. The stock is undervalued and the high quality of its businesses reduces our downside risk.

Berkshire is well-known for its Chairman and CEO, the famous value investor Warren Buffett. The company's most important businesses are insurance and reinsurance, but it also owns other massive assets such as the Burlington Northern Santa Fe railroad, purchased for a total of US$44 billion in 2009, and MidAmerican Energy, which owns utilities and energy infrastructure projects. Every year Berkshire seems to acquire more operating companies. In September, the company acquired specialty chemical maker Lubrizol for $9 billion.

So why did we buy it now and not earlier? Well, we have liked the stock for a long time, but the company's announcement in late September that it would be doing share repurchases pushed us to act. Berkshire's board authorized the repurchase of shares at prices no higher than a 10% premium over book value. We read this as a clear signal that the board felt the shares are undervalued. The buyback program improves the risk-reward calculation for the stock, as it could help put a floor under the shares if they decline.

In late October, we bought **PepsiCo Inc**., another undervalued blue chip, at $62.92 for the Total Return Portfolio and the High Yield Portfolio. To put that price in historical context, the shares traded above $50 way back in 2002, when investors were more enthusiastic about the company's prospects but sales and EPS were far lower. Pepsi sells several recognizable products other than Pepsi cola, including Doritos chips, Gatorade, Aquafina water, Quaker oatmeal and Tropicana orange juice. It is an impressive stable of brands.

There are so many positives about this company. The company has a great long-term track record of earnings and dividend growth. The company has raised its dividend each year for 39 consecutive years and currently yields over 3%, while paying out less than half its profits in dividends.

Over the past 20 years the company has usually received a premium valuation, often selling at a price to earnings (PE) multiple around the low to mid 20s. More recently, the company's future prospects remain positive, but the valuation has dropped to a low to mid teens PE multiple. For a business of Pepsi's quality and track record, we believe that is good value.

We also like the fact that Pepsi sells its products in almost 200 countries around the world and gets almost half its revenue outside the US. This exposure to faster growing economies should help fuel future growth. We envision 6-8% EPS growth per year over the next five years. Some of that EPS growth will probably be created by continued share repurchases reducing the number of outstanding shares.

A Turnaround Story

General Electric Co. is an enormous 130-year-old company that has been a member of the Dow Jones Industrial Average since 1896. The 2008 global recession and financial crisis really hammered the company. In contrast with Berkshire and Pepsi, GE made significant strategic errors, so it is fair to label it a turnaround. We think the errors are being corrected, so we bought the stock at $17.60 in late December for the Total Return and High Yield Portfolios. To put that price in context, GE shares traded over $40 as far back as 2002.

Most of the errors occurred in the company's GE Capital Division. GE Capital was founded in 1932 to finance customer purchases of GE's products. In recent years, GE Capital expanded into numerous other financial services and took on too much leverage and risk. Notable strategic errors included failed entries into subprime lending in the U.S. and consumer lending in Japan as well as over-reliance on short-term funding from commercial paper markets, causing liquidity fears during the financial crisis. These errors caused GE to dilute shareholders through a share offering in 2008 and to cut its dividend sharply in 2009. Instead of seeing the company as an industrial powerhouse, investors started to characterize it as a failing financial services company with some industrial businesses attached.

We think the bulk of these problems are now fading in importance and perception will change. Management is shrinking the amount of risk at GE Capital. GE's core businesses such as energy infrastructure, aviation, healthcare and transportation are performing well and winning many new customer orders. The company has guided investors to expect double digit earnings growth in 2012. GE has also been raising its dividend, which is still far from previous levels.

In 2007, GE earned over $2 per share and paid $1.15 per share in dividends. If the company can get back to these levels in the next two years we could see a stock price in the mid $20s and a dividend yield above 4%.

<u>Undervalued Growth Stocks</u>

High quality rapidly growing companies usually sell at elevated prices relative to their earnings and dividends. We typically pass on them because we find them too expensive and therefore too risky. Sometimes a high quality growth stock drops to the point where we become comfortable enough with the valuation to buy.

In late October, we purchased **Ritchie Bros. Auctioneers Inc.** at $19.40 for the Total Return Portfolio. Ritchie Bros. is the world's leading auctioneer of industrial equipment, operating through over 110 locations around the world. At $19.40, the stock was trading around 18x Raymond James analyst estimates of 2012 EPS.[3] This multiple is higher than what we have paid for most companies in our portfolio, but Ritchie Bros. has rarely traded as low as that during the past decade.

The company has an excellent track record, good future prospects and a strong competitive position. Ritchie Bros. has grown its EPS at a compounded annual rate of 13% over the past decade.[4] Its competitive position is so strong that Raymond James analyst Ben Cherniavsky stated, "Ritchie arguably is to the industrial auction business what Starbucks is to coffee." Competitors cannot easily recreate the business that Ritchie Bros. has, even with lots of capital investment, as there are significant barriers to entry:

> "The company has said in the past that its gross auction sales exceed the combined sales of its 40 largest auction competitors…. Ritchie is the dominant player in a highly fragmented industry…. Ritchie's key competitive advantage is its long-standing reputation for holding fair, clean, and highly efficient unreserved auctions.
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> An unreserved auction is one in which the seller cannot bid against his own equipment nor can he put it on the block with a minimum price attached…. Anybody can hang a shingle out the door and start an auction company; but the barriers to entry go sky-high if the auctioneer insists that all equipment gets sold without exception for the last bid offered—period! This precondition makes consignors very reluctant.
>
> And without consignors an auctioneer can't even begin to look for bidders….Sellers send their equipment to a Ritchie Bros. auction because they know from the past that enough buyers will be there to support a

> strong price; they also know that an unreserved auction means everything always sells at a Ritchie Bros. event, which when combined with a deep pool of bidders, provides a compelling source of liquidity that no other channel to the market can replicate. The buyers, as noted, come to a Ritchie auction because they know there will be plenty of equipment for sale and that all transactions are done in a completely transparent market.
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> In this scenario, a vicious cycle quickly turns into a virtuous—and largely impenetrable—cycle in which more buyers come because more equipment will be on auction and more sellers come because more buyers are coming."[5]

We think the shares could easily trade into the mid-20s. In fact, they are already over $23 as we are writing.

We purchased another undervalued growth stock, **Calfrac Well Services Ltd.,** in late December at $26.74 for the Total Return Portfolio. Calfrac is an oil and gas services company operating in Canada, the U.S., Latin America and Russia. Calfrac specializes in technologies that increase flow rates from oil and gas wells. These technologies are increasingly important, as there has been substantial growth in the number of wells targeting "tight" oil and gas (petroleum trapped in low porosity rocks) requiring extra stimulation to flow to surface.

Calfrac is trading at roughly 6 times analysts' estimates of 2012 earnings. With double digit revenue and earnings growth expected in 2012, the stock represents a good combination of growth and value.

Underappreciated Companies with Major Growth Catalysts

Companies can sometimes become undervalued because market participants fail to appreciate the significance of a material change in their business.

Our purchase of additional shares of **Fortress Paper Ltd.** in late October at $38.60 for the Total Return Portfolio is an attempt to capitalize on this type of undervaluation.

Fortress, headquartered in Vancouver, produces security and specialty papers, wallpaper, and dissolving pulp. The company bought a pulp mill in Thurso, Quebec for a minimal sum because its former business of producing hardwood pulp for specialty paper was no longer viable. Fortress then transformed it into a mill for producing dissolving pulp that is used in the manufacture of rayon, a cotton substitute that is in high demand in Asia.

In early December, the company announced the commencement of dissolving pulp operations at the Thurso mill. This was a material milestone, and the stock has been moving higher recently. The stock still only trades just under 9x 2012 Raymond James estimates of EPS and the company's enterprise value (equity plus debt) is only valued at just above 6x 2012 RJ estimates of EBITDA.[6]

We also bought **Penn West Petroleum Ltd.** in late December at $20.18 for the High Yield Portfolio. Penn West is still perceived by many as a high yield slow growth oil and gas producer with a huge land position but little upside. However, due to advances in tight oil drilling technology, there is a great deal of upside embedded in the company's 6 million acres of land in Western Canada.[7] The company believes that it has the most leverage to large scale oil development using horizontal multistage fracturing technology of any company in North America. We expect significant gains in the company's revenues, earnings and cash flow in 2012. This growth potential costs today's buyer only approximately 6x analyst estimates of 2012 cash flow per share.

Conclusion

Unfortunately we do not have space to discuss all transactions in the quarter for both portfolios, but it is worth mentioning in brief that we added more shares of French oil supermajor Total S.A. to the High Yield Portfolio, and shares of Central Fund of Canada (which holds gold and silver bullion), and more shares of Canadian oil company Cenovus Energy to the Total Return Portfolio. Taking advantage of volatility, we added some Silver Wheaton at $29.99 and trimmed it at $34.67 in late October in the Total Return Portfolio. Bank of New York Mellon and Vermilion Energy exited the Total Return Portfolio, the former at a loss, the latter at a significant gain.

This edition of the Armstrong Schmidt Perspective has been enjoyable for us to write, as we have taken a break from macroeconomic commentary that dominates some of our past editions to focus on individual stock selection. We hope it familiarizes readers with our stock selection method, which focuses on

undervalued high quality companies with good track records and shareholder-friendly practices like sustainable dividends and timely share buybacks.

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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] Value Line Investment Survey, Berkshire Hathaway December 16, 2011 Report
[3] Raymond James Ltd., Richie Bros. Auctioneers November 1, 2011 Company Comment
[4] Raymond James Ltd., Richie Bros. Auctioneers October 14, 2011 Company Comment (p.7)
[5] Raymond James Ltd., Richie Bros. Auctioneers October 14, 2011 Company Comment (p.3)
[6] Raymond James Ltd., Fortress Paper January 10, 2012 Company Comment
[7] Penn West Presentation to CIBC 15th Annual Whistler Institutional Investor Conference, January 19, 2012

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