Quiet Counsel

Winter 2015
Investment Outlook

like what you see.

Leith Wheeler
INVESTMENT COUNSEL LTD.

Quiet Money.

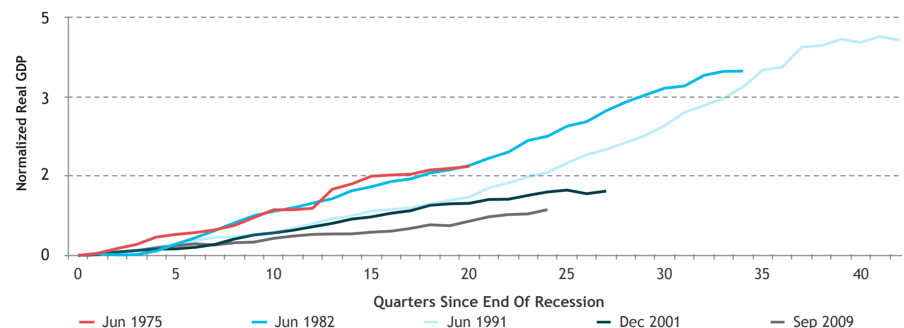
Unusual Times

We are operating in some unusual times in the financial industry today. The last time Government policy makers gave the economy a kick-start to this extent was during the Great Depression with Roosevelt's New Deal. Adding to the magnitude, we have not seen economic stimulus on a global scale like this before either. Central banks around the World have been extremely accommodating for investment and spending with their low interest rates and economic stimulus plans. What's most unusual is despite the length and strength of the economic stimulus packages, they have collectively had little effect on improving the World economy.

We are going on six years since the Financial Crisis ended and the push for economic stimulus began, yet we have only seen a very modest recovery in the economy, which is illustrated by the U.S. economic data in the chart below.

Download previous newsletters, and read some of Our Ideas online at:
LeithWheeler.com

US Real Economic Expansion
Source: Bureau Of Economic Analysis, Leith Wheeler Investment Counsel



US Real Economic Expansion

The economic recovery period after most recessions is typically between three and five years in length. Our internal research shows that when a recession is coupled with a financial crisis, like we saw in 2008, this recovery period can take twice as long. Despite this, here we are over half way through what was predicted to be a long, slow recovery and it would seem despite the aforementioned unprecedented stimulus, the global economy has been in suspended animation, not expanding much and not retracting.

Apart from the current stimulus having surprisingly little effect on economic growth, the other worrisome aspect of the current economic environment is that no one knows how it will end or what other unintended consequences may occur.

"You ask me what's going to happen? Hell, I don't know what's going to happen. I regard it all as very weird. If interest rates go to zero and all the governments in the world print money like crazy and prices go down – of course I'm confused. Anybody who is intelligent who is not confused doesn't understand the situation very well. If you find it puzzling, your brain is working correctly."

- Charlie Munger 2015

One unintended consequence of this prolonged stimulus is investors' insatiable appetite for growth from their investments. With anemic growth from the economy, investors have been seeking out and paying dearly for investments with higher growth expectations. This has led to an extreme divergence in short-term investment returns between sectors, regions and companies.

In a manner of speaking, a line has been drawn between value and growth investments. Investors are currently paying the highest premiums for companies that can deliver earnings growth in spite of the lack of economic growth. The most notable examples of companies currently commanding this growth premium can be found in the Technology and Health Care sectors in the U.S..

Top 10 Contributors to S&P 500 Return in 2015
As of September 30, 2015

Company	Price To Earnings Ratio*
Amazon	Negative
Google	29.8x
Starbucks	36.2x
Facebook	91.7x
Nike	31.1x
Home Depot	22.7x
Netflix	232.4x
Eli Lilly & Co.	30.3x
UnitedHealth Group	18.7x
Kraft Foods Group	25.0x*
Mean	**30.3x**
Average	**57.5x**
S&P 500	**17.0x**

***Source: Bloomberg** *Acquired by Heinz, a private company, for approximately 25x earnings2015.

The important question in our minds as value investors then understandably becomes; "when do these companies become too expensive?" What is considered expensive takes some judgment, but most value managers would consider investments trading at prices greater than 20 times current earnings (P/E), or more than 2 times book value, to be too expensive. Based on these criteria, only one of the top 10 performing stocks in the table above is priced attractively enough for a value manager to own unless there are extenuating circumstances.

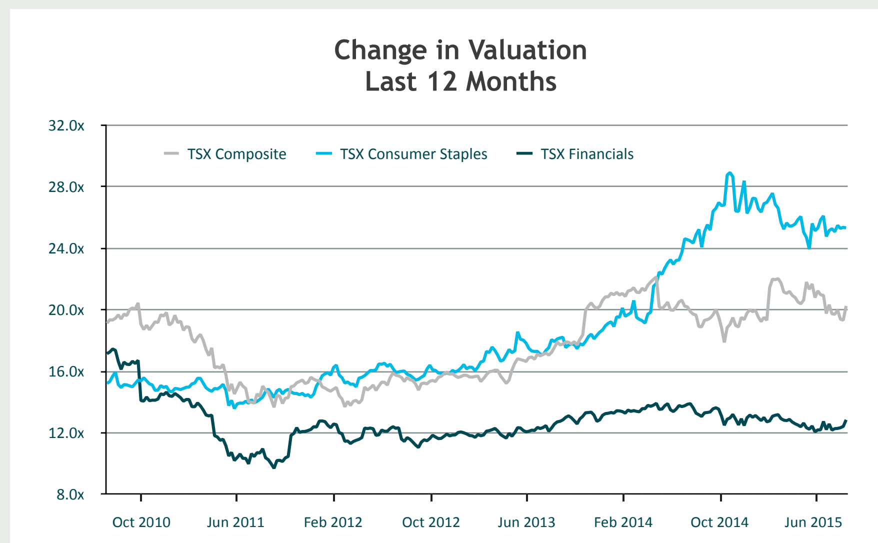
Our follow up questions on the same line of thinking are: "what about the remainder of the U.S. stock market, how does it compare?" and "what if we simply divide the S&P 500 index between those companies trading above 20 times earnings and those trading below 20 times one year ago, how have they performed over the past 12 months?"

The answer is the 'expensive' group (trading →20x) increased in value +6.6% on average for the year ending September 30th and the 'cheaper' group (trading ←20x) declined -4.1% over the same period in US$ terms. Expensive companies became more expensive and cheap companies have become cheaper. This might seem strange, but this trend is not completely without historical precedent over short time periods. What is unique about the current environment is the fact that this trend has persisted in the U.S. for over three years now.

However, as illustrated by the table below, it has certainly become more pronounced over the past 12 months. Given Value has outperformed Growth roughly half the time over the past 25 years, we find it even more unusual that in the U.S., the S&P Growth index has outperformed its Value counterpart in 7 of the last 9 years.

Annualized US$ Performance (09/30/2015)	YTD	4 Year
S&P 500 Growth[1]	13.0%	25.0%
S&P 500 Value	5.5%	23.4%
Difference	**+7.5%**	**+1.6%**

***Source: Standard & Poors** [1]S&P divide the S&P 500 constituents into Growth and Value based on; sales growth, ratio of earnings change to price, and momentum.



***Footnote -** P/E was exchanged for EV/EBITDA on energy companies in Canada.

In Canada, the TSX composite index was down -8.4% for the 12 months ending September 30th. When we conduct a similar analysis in Canada as the one previously discussed in the U.S., the stocks that began the period with P/E multiples* greater than 20x, our 'expensive' group, showed a small decline at -2.8%, while the 'cheaper' group with valuations less than 20x became much cheaper with an average decline of -21.0%.

The sectors which were the most expensive in Canada over the past 12 months, included; Consumer Staples, Technology, Utilities, Real Estate Investment Trusts, and Healthcare, and most became more expensive. This phenomenon is supported by the average P/E of the Consumer Staples sector outlined in the graph to the left.

As bottom-up stock pickers, we explored this trend further by examining the fundamentals of three well known businesses in Canada; the largest grocer, bank and pharmaceutical companies on the Toronto Stock Exchange. As the table at the top of the next page illustrates, the relationship between the business results for each company relative to its current market valuation and recent performance is striking.

12 months results as of September 30, 2015

	Loblaw Companies	Royal Bank	Valeant Pharmaceuticals
Return on Equity	5.8%	18.6%	10.6%
Dividend Yield	1.4%	4.1%	0%
Dividend Growth	2.1%	8.5%	N/A
Payment Ratio	45.0%	46.6%	0%
Total Return	**24.5%**	**-4.2%**	**62.3%**
P/E	**32.3x**	**11.6x**	**72.3x**

***Source: Bloomberg**

The Royal Bank (RBC) has delivered better results for their shareholders than Loblaw and Valeant in every category except Total Return. RBC generated a return on shareholder's equity three times greater than Loblaw and almost twice that of Valeant. RBC also paid a dividend almost three times larger than Loblaw, while Valeant does not pay a dividend to shareholders. Despite these fundamentals, the market rewarded Loblaw and Valeant shareholders with a 24% and 62% increase in share price, respectively, while RBC's share price declined over the same period. As mentioned earlier, this performance asymmetry can happen over short periods of time, but over the long term our experience tells us the market will reward the company with better operating results.

As we have noted in previous newsletters and client communi-cations, there have been signs of economic recovery in the U.S. and the U.K. in the past year. Perhaps this represents the start of a 5 or 10 year global economic recovery. If this proves to be the case and the market has been rewarding expensive companies over the past few years while the economy has been only sputtering, where should wise investors be looking today? Is the increase we have seen in Material, Energy and Financial company valuations in October an indication the market is starting to recognize the value in these unloved sectors and beginning to position itself for the long awaited economic recovery?

Either way, as our clients know, we don't believe timing the market for a shift from growth to value investments is a strategy that has been proven successful over the long-term. Instead, we continue to focus our efforts on seeking out and buying high quality, attractively priced companies and waiting for the market to recognize their value. From this perspective, the past year has been a wonderful time to accumulate positions in high quality, out of favour businesses and wait. Regardless of when the economic recovery may begin, we will remain committed to our value investment approach in the confidence that for patient investors, it is the most profitable approach over the long term.

This article is not intended to provide advice, recommendations or offers to buy or sell any product or service. The information provided is compiled from our own research that we believe to be reasonable and accurate at the time of writing, but is subject to change without notice. Forward looking statements are based on our assumptions, results could differ materially.

Author: Michael Schaab, CA CPA CFA
Vice President, Portfolio Manager

Editor: Michael Job, CFA
Portfolio Manager

LeithWheeler.com

Vancouver Office
Suite 1500 400 Burrard Street
Vancouver, British Columbia V6C 3A6
Tel: 604.683.3391 Fax: 604.683.0323

Calgary Office
Suite 570 1100 1st Street SE
Calgary, Alberta T2G 1B1
Tel: 403.648.4846 Fax: 403.648.4862

Leith Wheeler INVESTMENT COUNSEL LTD.
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