

Mental strength is really important because you either win or lose in your mind. And I'm not solely talking about sporting matches, boxing events - anything you do, you do it first with your mental strength. ---Wladimir Klitschko, former world champion boxer

Boxing, known as the “sweet science”, and investing have similar traits. Many, if not most, boxing spectators are unable to see past boxing’s physical and aggressive nature. They do not see it as a skillful craft that involves strategy and forethought – much like a chess match. More to the point, they don’t understand the great athletes in the ring are able to shake off the stinging blows and carry on with their predetermined plan to defeat their opponent.

Investing is similar in that, from the outside at least, what our skilled team does looks like something anyone can do. And in any short period that may be true. But the real strength of character comes when Mr. Market lands a solid punch. The ability to absorb the impact and keep your bearings is something learned with time and experience. A good portfolio team can watch excellent investments be pummelled, but one learns over time it’s not the number of punches you absorb, but those you “slip” that avoids putting you “on the canvas”.

There is no question that 2015 was a year of increased market volatility given today’s unstable world. We saw unrest in the Middle East, increased fears of terrorism, tensions in Europe, a slowing Chinese economy, a guessing game over what the Fed would do with interest rates, and myriad headlines from U.S. politicians running for president. These factors, among others, made investors edgy and contributed to a low-growth market sentiment that was widely touted by the press.

Locally, the past year has been a battle. Following a reasonable start to the year, beginning in early April the Canadian index collapsed over 14% through year end. Not the worst result seen over the past few decades, but portfolios – ours and our competitors – took a pummelling.

Fortunately, with a great team running a proven discipline, we managed to miss a lot of the businesses that landed heavy blows to competitor portfolios. Yes, we added names to our portfolio throughout the year, but generally at levels we deemed sufficiently discounted to their intrinsic value to limit potential further deterioration.

Given our experience of the past year, it may be more apt to describe the Laurus team as prize fighters – bloodied, beaten, and yet, within our own “ring”, victorious.

The Good Old Days

One of the quirky aspects about getting older is the penchant to reminisce about “the good old days”. In our industry, these would be days when hedge funds and “activists” were bit players in the market. Algorithmic trading hadn’t been heard of (nor had laptops for that matter). And the negative trading effects of ETF rebalancing were completely unknown. Back in those good old days, we were challenged by institutional “front-running” – which was surprisingly prevalent – and “window dressing” by firms using late trading to artificially prop up prices at month/year-end.

This was a year of incredible volatility exacerbated by the “algorithmics”. Given the quiet economy, these price manipulators created price spikes in three different periods to levels last seen coming out of the recessionary period. In the last couple of months of the year, index price swings of 5% each way in three separate weekly periods were experienced by the US large cap market. August was particularly erratic, but September and December were nasty as well.

Of course one should never underestimate the fear sown by the Fourth Estate. Despite persistent editorial hand-wringing about the effects of Greece (“Grexit”), China (slowing growth), Fed rate hikes (slowing the economy through a rising greenback) and countless other bits and pieces, the US stock market remains just shy of its all-time highs. Not so in Canada; the rapid acceleration of the US dollar has put a major damper on our holiday vacations, never mind the impact on the cost of our imported goods. Combine that with a colossal drop in energy prices, and you have a Canadian economy barely eeking out growth.

At last measure, the Canadian market was one of the worst performers for 2015, with only Greece and Singapore turning in lower returns. The heavy commodity bias of our economy, along with low growth projections in the coming year, have made Canada an investing outcast.

Don’t be fooled though. Despite the pass-through effects of import pricing, our export goods will be much cheaper with the lower loonie which will benefit corporate revenue growth. Further, more than two-thirds of the stocks in the TSX Index had a negative year – there are certainly better buying opportunities currently that there were a year ago. And with energy prices finishing the year at decade lows, the year-over-year comparables - so closely watched by the street - will be low hurdles to jump over in the coming year. That will make the Canadian market look much rosier in 2016.

However, with all of the mindless computer trading these days, volatility will likely continue to be the norm – at least until a definitive pattern emerges. Which leaves me longing for the old days before quants controlled the markets. Of course, to paraphrase Jon Stewart “the only reason you think the country was better during your childhood is because you were a kid.”

“Danger, Will Robinson”

Along the lines of yearning for the good old days, this section title comes from the quirky sci-fi television series “Lost in Space” circa 1965 through 1968.

Thinking about the quants leads me to ponder the continued expansion of the “robo-advisor”. These on-line wealth management services provide automated algorithm-based portfolio management advice without the use of human financial planners. The growth of these platforms is one of the top themes in the industry presently and they are certainly a disruptive force. But will they replace the financial planner? I don’t think so...but they could be used to enhance the advisor business.

A recent study, "Financial Planning in 2015: Today's Demands, Tomorrow's Challenges," was conducted by the Financial Planning Association and polled 771 financial professionals throughout the United States. When asked how robo-advisor technology could be integrated, respondents discussed using it as a supplement to the advice they provide, outsourcing investment management to technology to focus on the value-add side of the business, creating a segmented service offering and targeting younger or cost-conscious clients. However, forty-two percent said they do not plan to utilize robo-advisor technology in their financial-planning offering to clients.

That may be whistling down a dark alley, but one has to wonder whether the vast majority of investors would be happy cozying up to their computer as opposed to working face-to-face with a planner. To be sure, the low fee aspect of the robo-advisor is likely attractive for small accounts who are exposed to exorbitant mutual fund fees. But it's not likely to shift the buying sentiment of a larger individual account requiring the specialization that can be achieved within segregated portfolio manager.

Coal in their Stocking?

I've been watching our new Federal government with great interest. Their penchant for shilling out photo ops and cozying up to whatever new project that seems to play well in the national press is bad enough, but, political bias aside, their recent focus on the beleaguered oil patch is a concern.

The Canadian Association of Petroleum Producers estimates 40,000 jobs have been lost directly in the industry and close to 100,000 jobs overall. They speculate that layoffs will continue into 2016 given the cuts in capital spending.

This is disturbing as the oil industry represents more than 10% of the national economy according to Natural Resources Canada. The fiscal environment for oil and gas companies is deteriorating. Tax rates on corporations are rising, royalty regimes are under review, tax incentives intended to spur activity are likely to be eliminated, and a new carbon pricing is in the works.

As most Canadians know, Bombardier, the rail and aerospace giant and one of the larger employers in Quebec, has been on the receiving end of billions of dollars in bailouts, breaks, and sweetheart contracts over the past few decades from the Quebec, Ontario, and federal governments and is a poster child for government handouts and corporate welfare.

Employing some 15,000 people in Quebec, Bombardier also has a large network of third party parts suppliers that employ thousands more. In defending the recent bailout, Quebec Premier Couillard referred to saving the 2,500 high paying jobs associated with the massively over-budget C-Series programme.

This is but a pittance compared to the losses in Alberta, yet politicians both inside and outside of Alberta don't seem to care. The contraction of the energy industry will have negative repercussions within the Canadian economy as a whole – but that negativity will be exacerbated by the lack of political support.

The energy industry has rarely, if ever, received any bailout money during a downturn nor is it typically requested or anticipated. Rather the industry takes its lumps, rationalizes, adapts, fixes itself and moves on, because that's what private-sector companies are supposed to do. Unfortunately, whether through ignorance or ideology, it appears our politicians are ensuring the energy patch will see nothing but coal in their stocking this Christmas...to the detriment of our economy.

Use of Free Cashflow

Barry Ritholtz recently wrote a wonderful article entitled "Why Management Loves Share Buybacks". In it, Mr. Ritholtz discussed the research report published by Research Affiliates casting doubt on whether there actually has been a reduction in share count due to share re-purchase programs.

This report suggests that buybacks are really thinly-veiled management compensation plans. It refers to the use of management stock options being exercised married with the proportionately-announced buybacks which then facilitates the ability for management to sell the new stock.

The timing of these buybacks is as big, if not bigger, an issue as their size. Caterpillar and WalMart for example, have re-purchased shares well above their currently listed price, well before they have thought through the use of cash needs in coming periods. From 1997 to 2012, Dell “purchased \$39 billion in shares -- more than the company has reported in net income over the entire course of its existence.”

But the best example set out was the \$13.6 billion share-buyback of Qualcomm over the prior five fiscal years. Despite this massive buyback the diluted share count of the company “actually increased by almost 41 million shares due to lucrative management stock options and awards”. And to put the icing on the cake, Qualcomm paid an average of \$56.14 a share, or about \$4 more that it currently trades for – meaning it overpaid by about \$1 billion of shareholder money.

Now this certainly isn’t the case for all companies, and the businesses we invest in would be good examples. However, it is worth understanding that the announcement of a share buy-back does not necessarily mean it benefits shareholders.

Free cash flow is an important consideration in measuring the profitability, and future capability, of a company. With increasing free cash flow management is given the choice to increase shareholder dividends, invest additional funds into developing new products and services thereby providing additional future growth to the company, or acquire smaller/weaker competitors. As a last resort, management might announce buying back stock.

This last step is a signal a business has run out of options for profitable growth. Yes, in the main it’s beneficial to shareholders (fewer shares to spread net income across). However, if the decision is made to exchange shares for currently cheap debt, we suggest investors beware. Yes, the street loves to crow about the percentage of outstanding shares a particular company is reducing...but it’s obviously seldom to the benefit of shareholders. Caveat emptor.

The Coming Year

A few suggestions have been made throughout this letter but, before summing up, I’d like to refer back to a comment made by Janet Yellen in a press conference last September:

“I think it’s a myth that expansions die of old age. I do not think that they die of old age. So the fact that this has been quite a long expansion doesn’t lead me to believe that it’s one that has, that its days are numbered. But the economy does get hit by shocks, and they were both positive shocks and negative shocks.”

As we look forward into 2016, there is higher probability for improving oil prices and growth in the Chinese economy leading to improved growth expectations, not only for the US but for the global economy as well. Not a given to be sure, but one needs to measure probability of events to navigate through the market milieu.

With the first interest rate increase behind us, and possible future increases set against future US economic growth, Yellen is giving us some indication she recognizes the shock we’ve seen in the past

while, yet also has a positive view of the coming period. Her focus/concern is about the potential for a boom ahead with the perspective that with a boom comes a bust.

We would not profess to be strong prognosticators of future events. We do know there are mispriced opportunities in North American stocks at the current time. Should the economic winds turn to our backs and out of our face, we would expect to have a reasonable year ahead of us.

The current economic expansion has been long but, as we've written previously, it looks to be only mid-cycle. In the boxing vernacular, we're midway through the bout, stung by a couple of low blows, but we're ahead on points. With our astute team continuing to stick to our disciplines that have proven out over many years (and through prior booms and busts), we expect to continue to protect our clients capital and prudently grow their investments into future years.

At this time, we would like to thank our clients, their advisors, and our readership for the confidence you've shown Laurus over the past year. Every year end also marks a new beginning. All of us at Laurus wish you the courage, faith, and strength of spirit to walk the difficult road ahead - along with the tenacity to achieve everything you desire.

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