The Opportunity Update – March 5th, 2014

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Track #1: Introduction – The Skinny on What I am Going to Speak To

Hi, this is Chris Raper, Senior Vice President & Portfolio Manager, Private Client Group of Raymond James Ltd. & co-founder of **The Dividend Value Discipline™**. Welcome to **The Opportunity Update**, which is being recorded for you in Victoria, B.C. on Thursday March 5th, 2015. Here is what we are going to cover today:

You are now listening to **Track #1: The Introduction**, where I give you the skinny on what I am going to speak to.

On **Track # 2: The Markets – How High Can U.S. Stocks Go?**, March 2015 started on an up note with the S&P 500 setting an all-time record high. Not surprisingly, "how high can U.S. stocks go?" is the current question on many investors' minds and thus the theme for this track. My short answer is: A lot higher than most of us think – I will walk you through the why and then follow my usual course giving you my current take on the world's best economic forecaster, the price of copper, then the energy complex and finally the Canadian dollar.

On **Track # 3: The Dividend Value Discipline™ – Out of Gas and Heading South**, we'll roll the clip since our last recording in late November, outlining the major transactions within the program and our thinking at the time of those decisions. The theme will become self-evident: Out of gas can be translated as out of the energy complex, and heading south is another way of saying choose tailwinds over headwinds. We have some great new companies that have joined our roster and I will give you some insight on what makes them great.

On **Track # 4: The Wrap Up – March: In like a Lamb, Out like a Lion!** I will present the key takeaways and then take the froth down a notch by outlining the things that worry me in this bull market environment, then finish up with where I expect to find compelling value propositions in the weeks ahead.

Track #5: Postscript I, is where I walk you through our core investment program, **The Dividend Value Discipline™**, its methodology, return objectives and all-in costs. This track is primarily for the benefit of potential clients who are being introduced to us by way of this recording. By the time you are done listening you will know what makes the process unique vis-à-vis our competition and whether or not you are interested in pursuing it any further. Not interested, not interested right now and let's talk further, are all perfectly acceptable answers.

Track #6 is Postscript II – again for the benefit of prospective clients. It will give you some insight on what to expect during our initial meeting, where we both want to answer the question, "Is there a fit between our services and your needs?"

In terms of legal requirements – the opinions that are expressed on this recording are mine. They may differ from those of Raymond James Ltd.

I am also required to tell you that Raymond James Ltd. is a member of the Canadian Investor Protection Fund, which is a good thing. If you are interested in those details, please ask me the next time we speak.

Finally, regarding investment jargon, when I say I am bullish, it means I expect things to go up – when I say I am bearish, it means I expect things to go down. If you catch me using industry jargon beyond that, I invite you to call me out – i.e. send an email to the office and believe me, my team will let me know.

That's a wrap on the skinny and off we go to Track # 2.

Track #2: The Markets – How High Can U.S. Stocks Go?

The S&P 500 busted through another all-time high on March 2nd, closing at the 2117 level. New highs understandably make some investors nervous and with good reason – when the above noted index hit its then all-time high of 1527 back in 2000, it rolled south over the next two years bottoming at roughly half of its former value. Slowly, ever so slowly if you were in the investment business, confidence and corporate profits were restored and we etched another high water mark in the fall of 2007 at the 1576 level, after which it promptly rolled south again losing over 50% of its value by the time we reached the March 2009 bottom. Thus, with yet another record high, the question that many investors are asking is how high can it go, and is it time to take the money and run?

To bring some rational thinking to that question, it really requires us to look at the earnings yield, which is a company's earnings per share divided by its share price, expressed in percentage terms. For example, a stock that is earning $1.00 per share and trading at $20.00, would have a 5% earnings yield. We also need to recognize that all investment decisions are made after a comparison to the alternatives. So let's look at the S&P 500 peaks of the years 2000 and 2007, compared to today. When the index hit its then all-time high back in year 2000, the earnings yield on those 500 stocks was roughly 3.5%, and 10 year U.S. government guaranteed bonds were yielding north of 6%. In other words, the "spread" was a negative 2.5%, which really tells you something about how optimistic investors were at that time. Presumably, rational investors would demand a higher rate of return from stocks over safer bonds; obviously, the math suggests that wasn't the case back in 2000. Let's look to the fall of 2007: When the S&P 500 peaked, its earnings yield was ~6% and 10 year U.S. government guaranteed bonds were at about 4.5% for a positive spread of, say, +1.5%. Yes, a little more rational, but we all know what happened in the 2008/2009 debacle. Today, with the S&P 500 at the 2100 level, the earnings yield is currently estimated at 5.6% for 2015 and 6.4% for 2016, so let's call it 6% for easy math. When we compare that to the available yield of 10 year U.S. government guaranteed bonds, now ~2%, we come up with a positive spread of 4%, so math wise you would have to conclude that the current value proposition for U.S. stocks looks a lot more compelling today than it did during the market peaks in 2000 and 2007.

We also need to remain cognizant that the yield on those 2% ten year bonds remains at 2% for ten very long years, whereas earnings tend to grow over time. I like the way Warren Buffet put it in his recent letter to Berkshire Hathaway shareholders. Quote, "Charlie and I have always considered a 'bet' on ever-rising U.S. prosperity to be very close to a sure thing.", unquote.

Adding to the "higher than we think" argument is the powerful incentive that most worldwide investors have to head for American shores. Here's why: The world's central bankers are in a race to see who can get to zero percent interest rates first. By way of example, in France a 10 year government guaranteed bond is currently yielding a whopping 0.66%, in the Netherlands the yield is 0.42%, and in Germany the number is 0.36%. Not to be outdone, Switzerland, Denmark, and Sweden have now moved to negative interest rates; that's right, you pay the government to keep your money safe. Now put yourself in the place of a German investor…"should I take 0.36% for the next ten years and a shrinking Euro, or move across the pond to a 2% U.S. government bond and a growing U.S. dollar? Wow, if I buy an ETF on the S&P 500, I'll get a 6% earnings yield and that yield can grow over time. What's not to like?" Of course, the more that trade happens, the more it becomes a self-reinforcing mechanism; unlike the year 2000, the math is a lot more rational. If you want to dig deeper on this race to zero theme and the resulting push on the U.S. dollar, please know that I have written extensively about it in the November edition of The Strategist and the special market dispatch released on January 29, 2015. Both are archived on our website in the "Market Insight" section.

My final argument for "higher than most of us think" revolves around the impact of lower oil prices. Unlike Canada, lower oil prices have a pretty strong correlation with higher U.S. stock prices. For a great historical look at oil prices, I reviewed it extensively in the February edition of The Strategist, which is also archived on our website. The jist of it is that $50.00 oil is not cheap oil; please know that inflation adjusted oil prices since 1870 have averaged $33.00 U.S. per barrel.

Does all the above guarantee a higher U.S. stock market? Absolutely not; any number of geopolitical and economic events can shift the equilibrium causing markets to move to the downside in short order. That's why we take the shock absorber approach with exposure to dividend paying equities, interest paying bonds, and cash. That way, when we get the inevitable hiccups, we have the ability to take advantage of the situation, selling bonds or trading cash for the improved value proposition in stocks. Today, there are still a lot of tailwinds pushing the U.S. markets higher, and in my 20 plus years in this business I have found it a lot easier to make money with the wind at my back. If the evidence changes, we'll change.

Okay, let's wind this track down with my usual comments on the world's best economic forecaster, the price of copper, this time with a twist as we get more and more interested in another leading economic indicator, the semi-conductor index. I will close with brief comments on the energy complex and what that portends for the Canadian dollar.

Dr. Copper, i.e. the price of copper, was trading a little under $3.00 when I left you back in late November, and it has rolled south to a low of $2.42 per pound in late January. Today it is residing at the ~$2.66 level and we would normally see that as a sign of slowing economic activity, and the truth is we have seen some softening in the 20+ leading indicators that our guru, Alex Vozian, tracks for us. That said, while we are seeing the rate of growth slow, we are not seeing contraction. Furthermore, there is a school of thought that within the developed economies, i.e. North America, the semi-conductor index is a much more important indicator than Dr. Copper, which is more applicable to say the economies of Asia. Please note that the semi-conductor index has just hit new all-time high. We also know that a strong U.S. dollar is a negative for commodity prices. My take is that when you weigh all the factors, the evidence still leans towards modest global economic growth.

Now to the energy complex, where it is all about oil: Yesterday, the *U.S. Energy Information Administration* announced yet another record stock pile of crude and U.S. oil production is still growing, up some 1.3 million barrels per day over this time last year. Again, historically speaking, $50.00 oil is not cheap oil. Two years out, the April 2017 futures contract is trading at $64.00 per barrel versus $70.00 per barrel on the last recording. Until we see the futures curve move further south, i.e. at or below $50.00, I do not believe that we are going to have much in the way of meaningful supply curtailment and I see that as the necessary precursor for higher oil prices. I remain in the lower for longer camp.

Finally the Canadian dollar, where I continue to be of the mindset that rallies should be used to lighten your horde of loonies. We have done that within The Dividend Value Discipline™, and it has certainly helped our short term performance numbers. As per the November edition of The Strategist, the mid 1980's bull market in the U.S. dollar saw its index run to a level of 160. Today, it is at a comparatively weak 96.5, yet punching through multi year highs. For reference, it was at 88 on our last recording. The bottom line is this: the trend is your friend.

On to track # 3.

Track #3: The Dividend Value Discipline™ – Out of Gas and Heading South

As we walk through the major buy/sell decisions made since late November, you will see a continuing de-emphasis on anything commodity related and a clear bias to money moving south of the 49th parallel. In other words, strategy wise not much has changed since our last recording.

Getting the "sell all's" out of the way, we eliminated our final position in mobile chip developer **Qualcomm (QCOM)**, for a gain of some 24% over a 30 month hold period. Our concerns revolved around unresolved collection issues in China; our sense being any untoward news would further evaporate investor confidence. As of today, it looks like our concerns were well founded.

Next up was the elimination of **Steel Dynamics (STLD)** in mid-January just north of $17.00 U.S. We bagged an 18% gain at the time, but the fact is I sold it too soon. Shortly thereafter it rallied to north of $20.00 which obviously would have been a much better out point. Our reasoning was the strength of the U.S. dollar translates into more competition from cheaper imports. That, coupled with the slowdown in the oil patch, means less steel demand for everything from drill pipe to rail cars.

The next elimination was a little closer to home. We sold long term holding **Boston Pizza Royalties Income Fund (BPF.UN)** just north of $21.00 per share in early February. If you were around in October of 2005, the overall gain was north of 60%. Thinking wise, I was concerned with its overweight exposure to Western Canada, aka the oil patch, and their menu's relatively high price point compared to say Tim Horton's or A&W.

We also exited our final position in **U.S. Bancorp (USB)**, snaring a return of 50% for a hold period of ~2 years. Essentially, the price at which we sold is what we believe the company to be worth.

Finally, the out of gas factor: In mid-February, we sold our final energy stock, **Suncor (SU)** just north of $39.00, bagging a mediocre return of 7% over a 15 month hold period. Post our review of the company's Q42014 earnings results, we were convinced that this high quality "go to" name was being bolstered in a flight to safety within the energy complex and, more importantly, was fully priced. Thus the sell decision, and at this point it looks like we were right. In time, we will go shopping for an upstream oil & gas producer or an oilfield service company, as that is where the bargains are typically found at the bottom of the cycle. For now, I see that time as being months or even years away.

So that is a lot more eliminations than usual and it speaks to our heading south moniker – here is what we did with the money.

We started with an anti-oil play: The purchase of U.S. retailer, **Macy's (M)**. With 840 stores in 45 states, the company needs little in the way of introduction. Not only did Macy's score high marks on our corporate culture study, the company has historically delivered high returns on capital, a growing dividend, and growing free cash flow. We like their decentralized decision making and their technology platforms which are "location specific" with local stores acting as omni-channel fulfilment centres for their online business. Bottom line: Macy's is a serious competitor for the mid-market consumer, a group that is benefiting from lower energy prices as consumers have more disposable income to spend.

Our next acquisition was **Watsco (WSO)**, the U.S.'s largest distributor of air conditioning, heating and refrigeration equipment; otherwise known as HVAC in industry parlance. You have to love this management team; their goal is to build a network of locations that provide the finest service and product availability for HVAC contractors. In many ways, the CEO acts like the Warren Buffett of HVAC. Tuck-in acquisitions, access to capital, and a commitment to growth by better serving the needs of its customers have resulted in an earnings consistency that is the envy of its peers. Decision making is decentralized, management tends to be hired from within, and we find the compensation structure to be in concert with shareholder interest. Our take is that WSO has built itself a 'narrow moat' business, given its significant scale and relationships with original equipment manufacturers. Industry-wise, we see pent-up demand in aging HVAC systems which were not replaced through the 2008/09 recession and the aftermath thereof. We expect good things to come.

Next was an initial stake in **Accenture (ACN)**, a management consulting, technology services, and outsourcing company, which operates in more than 200 cities and 56 countries. We see ACN as a wide moat business with tailwinds that are going to make it increasingly tough to compete against. Specifically, the move to "cloud computing" has translated to less emphasis on proprietary vendors (think IBM) to a more open architecture. This is where the consultants at ACN have an edge, as they are free to recommend whatever system is going to work best for their client. Their moat is further enhanced by their global reach and wide array of expertise. In effect, ACN is a "brain trust" working on solving the most pressing problems of the world's largest companies, and getting well paid to do it. Culture wise, they are focused on attracting the best talent in the best locations. The median management tenure is 32 years with all key executives hired from within. Finally, ACN has demonstrated their commitment to shareholders with a compensation system that is aligned with shareholder interests and an increasing dividend over the last few years. We expect more of the same.

Last, but not least, we acquired a stake in an outstanding global healthcare logistics and distribution business by purchasing **McKesson Corporation (MCK)**. Their mission is to create a health care system that leads to lower costs, fewer mistakes and higher quality. The company scored high marks on the culture front: Management has long tenures and they are highly focused on efficiencies, practicing the “Six Sigma” management philosophy. They are obviously effective as they have attracted major clients like CVS, Rite Aid, and Wal-Mart. That said, they are smart to not get too concentrated and have worked hard on broadening their customer base with a huge number of independents. Our take is that MCK has built a defensible position in the marketplace and its ongoing high return on capital provides further evidence to support our “wide moat” designation. The company has a long history of being shareholder friendly, returning cash to shareholders primarily via share buybacks. Given the demographic tailwind of increasing drug consumption, we expect the impressive track record to continue.

Well, that’s it for the buys and sells, and yes, I am out of breath! If you want to know where I see the opportunities in the weeks ahead, you’ll have to listen to Track #4 and that’s where we are going, right now.

Track #4: The Wrap Up – March: In like a Lamb, Out like a Lion!

First the takeaways:

Track # 1 – a reminder, the opinions that are expressed on this recording are mine. They may differ from those of Raymond James Ltd.

Track # 2 – The Markets – How High Can U.S. Stocks Go?
The short answer is probably a lot higher than most of us think. While it is important to remember that markets don't go up in a straight line, the recent high water mark in U.S. stocks should not scare us. A look under the hood still presents a pretty compelling value proposition relative to the alternatives. The race to zero and beyond in global interest rates and the resulting weaker currencies will continue to draw money to American shores, and that is a powerful tailwind for the U.S. dollar and U.S. stocks and bonds. Dr. Copper is weakening whereas a lot of our other economic indicators remain strong, although the rate of growth is slowing. Lower oil prices are a boost for global economic growth and with the semi-conductor index pegging new highs, it is at least plausible that growth continues its upward trajectory. Canadian dollar wise, rallies should be used to lighten your horde of loonies.

Track # 3 – The Dividend Value Discipline™ – Out of Gas and Heading South – yes, we exited the last of our energy producer stocks and some others which we fear are going to get sideswiped in the aftermath of lower oil prices. We have used the money to acquire some great companies south of the 49th parallel, and I don't see that trend changing anytime soon.

Now to "In like a Lamb, Out like a Lion" – I do not want to leave you with the impression that I am a raging bull on the U.S. stock market; I am not. Whereas I can find some pretty good reasons to participate, I also recognize that there are going to be some bumps and they usually occur when there is no fear and right now all my fear indicators are singing, "don't worry be happy". That makes me nervous short term and thus the reason we are currently at ~63% in dividend paying stocks as opposed to our normal 70%. As I look to the weeks ahead, I am becoming increasingly interested in acquiring names in the small to mid-cap space within the U.S. markets. It is there that I see evidence of value, and most of those companies receive all their income in U.S. dollars, unlike the multi nationals. Sector wise, I am biased to the consumer discretionary space, the non-bank financials, and, given the strength in the semi-conductor index, technology.

That concludes our key takeaways. To our clients, thank you. I appreciate you taking the time to listen. It allows us to spend our meeting time focusing on the issues that are important to you and your family.

To potential clients listening – thank you for your interest. The Opportunity Update is one of three quarterly communications pieces that we produce. They are designed to keep you informed, but not involved on a day-to-day basis. If you are interested in past productions, they are all archived on our website, www.chrisraper.com under the menu titled "Our Market Insight". Prior to meeting us face to face, you will want to listen to Postscript I where I deal with the methodology of The Dividend Value Discipline™ and outline what makes the program unique versus our competition. By the time you are done listening you will know whether or not a meeting is in order.

Assuming the answer is yes, you will then want to move to Postscript II, where I outline what you can expect during our initial meeting where we both want to answer the question, "Is There a Fit?"

On behalf of the entire team here at CR&A, this is Chris Raper, bidding you good day and may God bless, from Victoria, BC, on Thursday March 5, 2015, which also happens to me my mother's 80th birthday, so Happy Birthday Mum, you continue to be a tremendous blessing to me and my family.

Track #5: Postscript I – The Dividend Value Discipline™ Methodology

The first thing to note is that **The Dividend Value Discipline™** is core to everything we do – meaning if we were approached by a prospective client and we determined that our trademarked investment process did not fit with their investment philosophy or their need, then we are not the right advisors for that particular client – there is no fit.

You should also be aware that nothing gets any more attention at our shop than this particular program. The lion's share of our client assets are allocated to the program and that includes our most senior people, my family, and me. The take away is that my team and I have huge vested interest in ensuring the success of the program.

The process is discretionary, meaning we make all of the buy and sell decisions and report to you after the fact. Post a new purchase, our normal course is to send an email outlining the background of the company and the rationale for the decision, five business days after it settles to your account. When we close out a position, we also send an email outlining the result and our rationale.

Our objectives for the program are:

1. Income every month – that can be paid out or reinvested
2. An acquisition process where we buy **only** those securities which become attractive on a "go forward" basis
3. Absolute returns of 8%+, each and every year.

On September 27, 2014, we marked our 12-year anniversary with account #1, pegging in a net to client return of +8.77% compounded annually. That said, I do not want to leave you with the impression that it has been a consistent +8% each and every year – that is the objective, it has not always been the result. Yes, we took a bath in 2008 – learned lots and more importantly put structures in place to prevent it from happening again. 2009 was an absolutely stellar year and by February 2011 we were on to new highs having fully recovered from the worst bear market in 70 years. Accounts that have been around since the start of the program have experienced one calendar year of negative returns. Looking towards Dec. 31, 2014, we are tracking at a meet or a beat, in nine of the past twelve calendar years. Those results have been achieved by focusing on three keys objectives, so let's walk through this with the illustration of a three legged stool.

The First Leg is Dividends

Every security that we buy you must provide some form of income – we do that because income makes portfolios inherently less volatile, i.e. less chance of loss. The analogy I like to use is that of an apartment block versus a piece of raw land – it is a lot easier to hold onto the apartment block in a tough real estate environment when you are getting a rent cheque every month. Income drives stability and absolute returns.

The Second Leg is Value

Our research function is in-house. We were one of the first private client teams in the industry to have a dedicated analyst on staff and that team has expanded since then. My objective was and still is, to get to the truth. I did not want to depend on any outside analysts that I had little or no contact with. One of the great things about having an in house investment team is that I can ask questions until I am satisfied that we have the right answers. We spend an inordinate amount of time studying the corporate culture. If you are interested in what that looks like, read **Good to Great** by Jim Collins – that is the yardstick we use to measure potential investments against. More recently, we have expanded our thinking on the importance of wide economic moats. You can hear more on that subject by archiving the September 2013 edition of this recording on our website. We believe that the focus on great corporate culture and wide economic moats gives us an edge. Anecdotally, we can provide you with lots of evidence to support that. I remain convinced that having your own people who are totally dedicated to the investment process, adds a lot of value not available at most other private client focused groups.

The Third Leg is Discipline

Here I refer to the buy/sell decisions. We often identify extremely attractive value propositions and then delay the buying decision, why? Because if you are the only guy in the world that sees it as undervalued, you can wait a very long time for the market to recognize that value – in other words, the stock price doesn't rise or worse still, it goes down! Those are not comfortable situations so we try to avoid them.

We buy when it is apparent that the market is starting to recognize the stock as undervalued. One of the most helpful indicators is positive relative strength – i.e. is the security in question starting to outperform its peer group and the market – because if it hasn't, there's little incentive in owning it. Sell decisions can be triggered by a number of things – i.e. when the company fails to materialize as expected, when a company's stock price exceeds what we believe it to be worth, negative relative strength, or when we find a better opportunity elsewhere. In reality it tends to be a combination of those factors.

Perhaps the most important part of the buy/sell discipline is the way we operate the program – we call it "The Buys Only Mandate". Unlike our competition, we only buy those securities which become attractively priced on a go forward basis, meaning if you start today and your brother starts three months from now, your portfolios are going to be different in the short-term, and more closely aligned the longer you are in the program together. As rational as that might seem, most people do the exact opposite. Every time you buy a mutual fund, you buy a pro-rata share of an existing portfolio – by definition, you got the buys, the holds and the near sells. To us, that is not rational – would Warren Buffett buy 100 companies in a single day? Were they all great value propositions? You should also be aware that most 3rd party money management programs work exactly the same way – they buy the basket. Our objective is the protection of your hard earned money and we believe that the buys only mandate is consistent with that objective.

Other key points to the program – a fully invested account would normally have 20 to 25 positions in it, so we are relatively concentrated. Our fees are 1.75% per annum plus the GST or HST – it is tax deductible for non-registered accounts. Our target returns: 8%+, net to you – roughly half of it coming in the form of income and half in the form of capital gain.

You should also know that when I buy for you, I buy for me – when I sell for you, I sell for me – same time same price – and that statement also applies to our most senior people as well. Furthermore, every person on our team participates in on our profit sharing plan, which means they have a vested interest in looking after you.

Generally speaking, we are looking to establish new relationships with new clients that have north of $1 million in investable assets – that said, I'm a lot more interested in where you are going, than where you are. If you have a credible plan to get to that number say within a three to five year period, we are very interested in meeting with you.

To conclude this track, if income and absolute returns are attractive to you, and you think that there may be a fit between your objectives and those of **The Dividend Value Discipline™**, then I would suggest a face to face meeting is in order. You can check out what to expect during that initial meeting by moving to Track # 6 – Is There a Fit and that is where we are going, right now.

Track #6: Postscript II – "Is There a Fit?"

Our objective – and presumably yours – during the first meeting is to figure out whether or not we have a basis for an ongoing relationship. In essence, can we work together? If so, will it be mutually beneficial? Job one is to get your tough questions off the table, so we encourage people to ask whatever is on their mind. Our responsibility is to be forthright with our answers, regardless of what it is that you might want to hear.

Before we enter into any new relationship one of the biggies we ask ourselves is, "can we add significant value"? To answer that question we need to learn some things about you, your family, your finances and what your ideal future looks like. If you are not really sure on the latter point, we have some thinking exercises that will take us through that process.

Next we will walk you through an a la carte menu of our services that are most applicable to you. We'll also outline how we will report to you and who the key relationship people will be. You will also have a very clear picture of the costs involved.

Before you leave we'll outline how we see our program fitting with your situation, or not. We will not ask you for a go/no go decision at the meeting and quite frankly, we don't want to be pressed for a decision that day either. We'll schedule a meeting of the minds call, say a week out, and then mutually agree on the best course of action from there.

At the end of the day, we are in the business of keeping our client's most challenging financial decisions consistent with their life goals. Our mission is ongoing progress towards those goals, and the result we seek is appreciative clients who are increasingly confident about their future.

So… if that process sounds engaging, I invite you to call and book some time. If you'd like further information, including access to our quarterly communication pieces, you can check us out on the web at www.chrisraper.com and send us an email from there.

This concludes "Is There a Fit".