

The Confused Fisherman!

Happy Friday the 13th! It's a rather gloomy end to the week in our fair city, wet and cold for this time of year. We won't let this get us down though, especially if one enjoys the fine sport of fly-fishing. One of the pleasures of living in Calgary is fishing the Bow River in the summertime. Unfortunately, over the years many people have discovered this to be an enjoyable pastime and the crowds on the river have increased, unless it's raining.

The average fisherman, (sorry - fisherperson), is likely to head out on a beautiful warm evening. If they end up shoulder to shoulder with someone, no problem. They often look to find where others are fishing giving them the sense that "obviously" this is where the fish are. Those same sheep we find following the herd in the stock market can be found in waders along the riverbank too. That whole concept of crowd psychology isn't just about the stock market.

Yes, valued reader, now it's time for the analogy you've likely been dreading. No, it's not the need to be patient or to look where others aren't. Rather fishing to me these days is like the stock market. I can't seem to figure out either one of them!

There are some very good companies trading at decent multiples. They are not at distressed levels like we saw in March of 2009, but valuations which should allow for a reasonable risk/return trade-off. Mutual fund money flows have shown significant cash piling into bond funds, yet we think there is excellent long term opportunity in many equities.

Before we give an example, we would be remiss if we didn't touch on the news flow from the US Federal Reserve this week. The summary is the Fed is still in place supporting the economy. We have often discussed the challenge it will be for the central bank to pass the baton to the private sector. Our caution as to the "real" health and sustainability of the economy has not changed. Consider for a moment the health of the real estate sector in the United States. US mortgage rates set a record low for the eighth straight week after the Federal Reserve said it would buy more government debt to support economic recovery. The average rate of a 30-year fixed-rate mortgage dropped to 4.44 percent, the lowest since 1971 when the data was first compiled. Even with such stimulus the market is terribly challenged to clear excess inventory. The real estate market is a key pillar to the financial system's health. Without a more stable and sustainable marketplace the repercussions to the average citizen and financial industry remain very serious.

Back to why we're having some trouble figuring out the stock market and investors. We think there are some expensive areas of the market which are based on strong global economic growth which we question. Yet, other businesses trade at reasonable valuations and have solid basic businesses which aren't as sensitive to economic growth rates.

For example, one of our largest holdings in the Canadian Large cap and Balanced Fund is Canadian Utilities (CU). The company is engaged in pipeline, natural gas and electricity transmission and distribution, as well as power generation, natural gas gathering and processing. Canadian Utilities

heats and powers our homes and this business is sustainable irrespective of the ebbs and flows of economic growth.

We anticipate dividend growth to continue alongside earnings growth for many years. The shares today trade at roughly 2 times book value and about 14 times earnings. This is not a dirt cheap valuation. But given the consistency and stability of this business it is one an investor should feel very confident holding even in these challenging and uncertain times. Let us give you an example of the potential. This is not scientific, but rather an exercise in highly error-prone extrapolation, in other words sophisticated financial analysis!

A little history on how management has created shareholder wealth. The book value per share in 1990 was \$7.04, today it is \$24.20, nearly 250% growth. The EPS in 1990 was \$0.87 and today is \$3.53, a gain of over 300%. The dividend in 1990 was \$0.68, today it is \$1.52 and has always grown.

Let us consider the future assuming the historical trends of the past 20 years stay somewhat intact. The company doubled their book value per share from 2000 to 2010. If they could do that again the book value would be around \$48.00 in 2020. Today the share price is \$47.00. In today's terms an investor is paying nearly 2 times price to book value (\$47/\$24) for the shares. Alternatively, for long term investors they may be paying somewhere near 1 times the potential book value of this business ten years out. Earnings in 2000 were \$1.80, today they are almost double that at \$3.50+. Theoretically, in 2020 earnings per share could approach \$7.00 if they could manage similar growth into the future. Today's P/E is about 14 times on current earnings, or 6.5 times the potential earnings power ten years from today. If we assume a 40% payout ratio in 2020, off of potential \$7.00 earnings, we could guess a dividend around \$2.80 or a 6% dividend yield on today's price.

This last point is very powerful. Think of the dividend yield of a business not on what it is today, but rather what it could be in the future. The dividend is not static like a bond interest payment, a good dividend should have the potential to grow. In the year 2000, the share price of CU was \$25 and the dividend yield was about 3.5%. For the investor who purchased the shares at that time they still have a \$25 cost base but are receiving \$1.52 in dividends, or a 6%+ yield. This is the power of growing dividends.

We look at high quality businesses like this not to predict the future to the penny but rather to understand our safety net should something go wrong. The challenging aspect about long term investing is that we may not know if our thesis was right or wrong for 10 years. How could this be? If the market remains fearful and good companies like CU get cheaper it may take longer to realize its investment potential. That being said, Canadian Utilities has been a very rewarding investment for the past decade and we have confidence it will continue to generate returns into the future. If we're somewhere in the ballpark with our analysis, CU today trades at 1 times book value, 6.5 times earnings, and a 6.0% dividend yield over a 10 year time horizon.

Here's where the fishing comes in again. Patience, patience, patience. I just hope I'm not waiting ten more years to catch a fish. Have a safe and happy weekend.