

# Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | JANUARY 2, 2014

**2013** was a wonderful year for Frontwater and equity investors alike. It was also a year full of potential economic disaster scenarios that never materialized. The economy never went over the fiscal cliff. Nor did Cyprus, a Mediterranean island with less than 1 million people, bring down the entire western civilization. And Republicans and Democrats were able to work together to prevent the US government from defaulting. All in all, it's good to be an equity investor once again. Still, our message going into 2014 is don't get caught up in the euphoria just yet, and keep the put protection rolling.

WRITTEN AND PRODUCED BY



With markets inching higher by the day, and the VIX (Volatility Index) nearing all-time lows, it is easy to forget that the markets were volatile at various times throughout the year. January, April, and October were months that had investors on edge.

Overlaying portfolios with put protection made it easier to ride out periods of chop-piness while remaining fully invested in the market.

In all likelihood, we expect the markets to carry their positive momentum into the first quarter of 2014 if only because more and more investors are shifting out of underperforming bonds and into equities.

But to quote Warren Buffett: "Be fearful when others are greedy, and greedy when others are fearful". Without a doubt, now is the time to be cautious.

On one hand, equities continue to look attractive in an environment of low inflation and low interest rates. On the other hand, stocks no longer look cheap in absolute terms.

It is a tad worrisome that US investors continued to bid up stock prices in 2013 to all-time highs despite a mediocre economy and corporate profits that were less than spectacular. Truth be told, this year's performance was not driven by corporate earnings but by investor sentiment.

At the beginning of the year, the price-to-earnings ratio on the S&P 500 was 13.5, meaning investors were paying roughly \$13.50 for every \$1 of earnings in the S&P 500. Now the S&P 500's P/E ratio is around 16.7 meaning investors are paying \$16.70 for every \$1 of earnings.

The implication here is that

## TSX COMPOSITE INDEX

	2010	2011	2012	2013	Return Since Inception (of Jan 2010)
Option Overlay Balance Portfolio	23.5%	-8.1%	15.4%	23.7%	12.8%
TSX	14.4%	-11.1%	4.0%	9.6%	3.8%

\*The performance figures shown above are a composite return after all fees and expenses for all paying accounts managed by Frontwater Capital that during each period incorporate option strategies as part of their overall investment objective, and include the return on all assets in those accounts, calculated as if all the assets had been pooled in one account and converted to Canadian currency. Results for individual accounts will vary widely depending, inter alia, on the actual securities held in each individual account, the objectives of the account owner and the date at which the account was opened. Comparisons to the TSX Composite Index are made for reference only and do not reflect the objectives or compositions of any or all accounts. Past performance is not indicative of future performance and no representation, express or implied, is made that individual accounts in future years will achieve similar results.

the S&P 500 increased by 19% in 2013 simply because investors were willing to pay 19% more to get the same dollar of earnings as in 2012.

It is possible to explain the expansion in the price earnings multiple as an astute move on the part of the market. This would be true if the U.S. economy were to demonstrate significant improvement in 2014, with ever expanding corporate profit margins to boot.

It just seems that the market is being overly optimistic. Profit margins are already at record highs, and corporations spent most of 2013 increasing their earnings by cost cutting and buying back stock. We could also reference several measures, two of them being the Robert Shiller's P/E ratio and the ratio of The Total Market Index to GNP, that suggests the market is overvalued.

As we head into 2014 with stock prices at lofty levels, we

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continue to believe that the best way to manage risk in this rising market is through profit taking for registered accounts and the use of option overlay strategies such as protective puts for non-registered ones.

Diversification is no longer the risk mitigation tool that it once was, and no longer can be counted on to mitigate volatility. Realizing capital gains in a tax sheltered vehicle and buying puts in non-registered accounts are optimal methods for managing volatility in a rising market. FLT



In last quarter's newsletter, we discussed the importance of the price-to-earnings ratio. In this issue, we take a different tack, illustrating the importance of qualitative analysis.

Numbers alone do not tell a complete story. Does your personal P&L reveal everything worth knowing about you? Can we accurately predict your income and job title five years from now based on your credit score and the equity in your home?

The point is that numbers are just that – numbers. They're helpful, but they are not absolute indicators. There is a reason that every prospectus reminds us that "past performance is not a guarantee of future results." That's why qualitative analysis is not only essential, but it can often be a much better predictor for long term competitiveness and earnings sustainability.



In 1979, Michael Porter of Harvard Business School devised a strategic framework for analyzing the 'profitability potential' and 'earnings attractiveness' of individual companies and industries as a whole. Not only do companies compete against rivals, but they are in a constant power struggle with customers, suppliers, potential new entrants, and

substitute goods. This logic became the basis and foundation for Porter's Five Forces – taught at business schools worldwide.

**THOSE FIVE FORCES ARE THREAT OF RIVALRY, THREAT OF SUBSTITUTES, THREAT OF NEW ENTRANTS, BARGAINING POWER OF CUSTOMERS AND BARGAINING POWER OF SUPPLIERS.**

Successful investors like Warren Buffet and Jeremy Grantham use Porter's Five Forces framework to help pinpoint profitability drivers and better assess whether companies have a sustainable business model capable of generating earnings for years to come.

## THREAT OF RIVALRY

Threat of Rivalry refers to the nature of competition between companies. Porter argues that Rivalry itself is not necessarily a bad thing – some rivalries are actually healthy, while others are destructive. Much of Warren Buffet's success can be attributed to selecting companies that operate in progressive industries that grow irrespective of cut-throat competition.

Coke and Pepsi are bitter rivals, but the two have created unprecedented shareholder value and market growth for the industry as a whole over the last 40 years. Here in Canada, banks and telecoms have been winners for shareholders without fail in spite of fierce competition.

But robust competition doesn't always lead to big profits. The rivalry between the various airlines as well as between auto manufacturers has a very destructive history. For instance, as these companies bitterly fight for market share, they often engage in price wars even if it assures hefty operating losses.

Beware of not only companies but industries that compete primarily on price and are thus susceptible to deadly price wars.

## THREAT OF SUBSTITUTES AND THREAT OF NEW ENTRANTS

Threat of Substitutes and Threat of New Entrants address pricing power. Pricing power as well as profit margins can quickly dissipate when barriers to enter an industry are low, or if customers can easily switch from their preferred product to a substitute.

Groupon suffered this inevitable fate. Within months of Groupon's successful IPO, dozens of copycat social coupon websites glutted the marketplace in a frenzy to share the Groupon gold. This created a ton of new and unexpected competition. Groupon's shares naturally crashed from its IPO price of \$20 to less than \$5, and trades today at around \$11.

Can the products or services of the companies we like be easily replicated by ambitious (and often skilled and innovative) newcomers?

In contrast, companies ranging from old economies like railways, utilities and banking to newer tech firms like Google and LinkedIn face little risk of new entrants coming to market. Even a company like Twitter, whose revenue model is still



unclear to me, faces little risk of a new entrant. Absent risk of strong competition, companies like these can rightfully trade at expensive multiples.

## BARGAINING POWER OF CUSTOMERS

Bargaining Power of Customers refers to the power struggle between customers, who obviously want to pay the least possible for a product or service, and companies who want to extract the highest price. How do companies succeed in charging above average prices? Brand awareness coupled with promoting a high end customer experience or product, are popular ways for building loyalty and making customers less price conscientious.

Proctor and Gamble, American Express, and National Oilwell Varco are favourites of Buffet because they are companies that have positioned themselves with strong brand awareness and superior quality products.

## BARGAINING POWER OF SUPPLIERS

Finally, Bargaining Power of Suppliers refers to the relationship between a company and its supplier base. The recent push-and-pull at Netflix is a great example of how bargaining power can shift back and forth between a company and its supplier.

It's well known that Netflix rents content from various sources and charges a monthly subscriber fee. When Netflix exploded onto the scene several years ago, it was a win-win for both Netflix and its video content suppliers, such as Warner Bros. and Starz. But by early 2011, those suppliers were growing envious of Netflix's massive profits. Power started to shift away from Netflix as Warner Bros. and Starz decided not only to not renew

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some of their library contracts, but also to compete directly. At the same time, Netflix's stock was spiraling downward, hitting a low of around \$80 in December 2011.

But then something extraordinary happened that was likely unforeseen by even Reed Hastings, Netflix CEO.

AMC, one of the smaller TV networks, had just finished airing Season 3 of a show about a fictitious Walter White - a brilliant, good natured, family loving, high school chemistry teacher who is diagnosed with cancer at age 50 and is given a few months to live. He decides to illegally produce crystal meth in order to leave a little inheritance to leave for his wife, who is pregnant with the couple's second child. Along with being highly entertaining, "Breaking Bad" delved deep into real life ethical issues.

While critics complimented the show, it only had about 1.5 million viewers after three seasons. AMC agreed to stream the old episodes on Netflix. Suddenly the show started to catch on like wildfire - on both Netflix and AMC. Airing old episodes on Netflix allowed viewers to quickly get caught up on the story line so they could jump into viewing the current season.

Contrary to traditional TV trends that predicts viewership will start to wane by the third season, Breaking Bad achieved the opposite and became more popular. By Season 6, the show was attracting more than 10 million viewers per episode on AMC. Having aired its final episode this past summer, Breaking Bad is now considered one of the best TV shows ever made. Furthermore, its creator, Vince



Gilligan, has openly credited Netflix for saving the show.

The streaming video pioneer accomplished something totally unexpected - Netflix showed that it had the power to take a TV show from obscurity to fame. In doing so, bargaining power shifted back to Netflix. This was exactly the type of event that TV executives salivate over. Overnight, Netflix was a hero again with its content suppliers.

Today, Netflix carries an abundance of existing TV shows to complement its flush library of videos. In the US, many TV episodes are added to Netflix within days of their original viewing, as networks intentionally make their content as accessible as possible - in hopes that one of their programs will become the next Breaking Bad.

Over the last 18 months, Netflix stock has risen from \$80 to \$350. Admittedly, we never bought into Netflix, but it remains an

interesting business case highlighting the bargaining power of companies with suppliers. It is also a pretty good argument for looking beyond the numbers to find the kind of potential value that every investor dreams of.

It is easy to see why Porter's Five Forces framework is taught to business students worldwide and applied by Frontwater in screening investments. Even as industries have folded and economies have shifted in the 35 years since Porter developed his framework, it remains a very reliable reference point for examining qualitative factors that can greatly affect a company's future success or failure.

Wise company executives take these forces seriously and plan for any number of various scenarios that may play out. Similarly, in making investment decisions, we have to consider more than just the numbers. FLT

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**JEFF KAMINKER, MBA, CFA** founded Frontwater Capital in 2009 and is a licensed Portfolio Manager. He is a member of the CFA Institute and holds an MBA and Engineering Degree (with Honours). He has more than 15 years capital markets experience.



Frontwater Capital offers an array of private wealth management services including investment management, insurance, financial planning, tax and retirement planning.

Frontwater Capital is licensed as Portfolio Manager, Commodity Trading Adviser, and Exempt Market Dealer.

## FRONTWATER SERVICES

We have the expertise to protect our investors from currency fluctuations on US dollar denominated assets. Our investors can invest in markets outside Canada without having to worry about volatile foreign exchange rates.

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- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments



**For the past several years, we at Frontwater have vigorously argued that gold is no safe haven and that the 30 year bull run in bonds was coming to an end. In 2013, our investors were amply rewarded for having almost no exposure to these asset classes.**

Without a doubt, fixed income hit a brick wall this year. For a down market, Cdn government bonds and preferred shares fared reasonably well, each falling a negligible 2%. REITs and long term corporate bonds were off 7%. But it was real return bonds that really took it on the chin falling 12% and not at all providing the safety net that many advisors touted.

Nothing however could compare to this year's demise in gold. While gold futures dropped more than 25% in value, gold companies listed

## THE UNDERACHIEVERS OF 2013: FIXED INCOME AND GOLD

on the TSX fell more than 47% as a group. Barrick shares at one point had dropped to price levels last seen in 1992.

All in all it feels good to watch this asset class get pummeled. Over the last 20 years, the gold industry has created little value for shareholders while often enriching senior managers.

It is also an industry that has a history of hedging production at exactly the wrong time. When gold prices are low, companies get nervous about their survival and lock in prices at the most inopportune times. Vice versa, when the price of gold is rising, management becomes arrogant and unloads their hedge book, thus exposing itself to falling gold prices.

Only 3 years ago in December 2009, Barrick spent \$5.6 billion to unwind its hedge book. Fast forward to December 2013 — with gold prices down 25% on the year, John Thornton, the new CEO of Barrick, announces a desire to return to gold hedging. Go figure.

But what really irks us here at Frontwater is the nonsense around gold production cost metrics. Some gold companies have found ways to report *negative* cash production costs. This makes absolutely no sense. How can any industry, any manufacturer produce an

item for *negative costs*. Are we to believe that somehow gold miners have magically discovered a way to produce something from nothing?

The trick to arrive at a negative production cost is an accounting one. Many gold companies take the revenue from a co-product (such as silver or platinum) and apply it as a credit towards the gold production costs. For example, if a mine produces both gold and silver, many miners will apply the revenue from the silver stream as a credit against the gold production. It would then be plausible to have negative gold production cost IF the revenue from the silver stream happened to be greater than the production cost of gold.

This accounting process hardly makes sense but is actually quite common practice for the industry, and perfectly legal.

Like any commodity, we expect the price of gold to eventually bounce back. Of course, the \$100,000 question is not *if* but *when*. Certainly, gold miners today look a lot more compelling at current levels. But any asset class that falls close to 50% in a year is generally not one that we would recommend to our conservative investors. For speculative investors, gold is an asset that you trade — get in and get out. FLT



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