Front Line Thinking

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

For many of our investors, this past quarter represented the 10th consecutive quarter of positive returns.

With our put protection, cash on hand, and hedges in place, we were well positioned to take advantage of the market's mini correction that occurred in late January and early February. While we accurately called for the correction in our last newsletter, it was the market's quick recovery back up that caught us off guard. That's not a bad thing and we should not complain that we have more paper gains as a result, but at the same time we hate to sound like a broken record. Don't get caught up in the euphoria and keep the put protection rolling.

WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL

What was most interesting this past quarter was the market's complete "shrug off" of Russia's incursion into the Ukraine. For a day or two, there were a few jitters in the market and then it was back to business as usual. Putin's decision to send troops into the Ukraine was met with utter indifference on Wall Street where stocks closed at record highs.

On a personal note, we continue to be somewhat suspicious of the recent market's gains even though we are pleased to see the portfolios increasing in value. First, we are starting to see a slowdown in the Chinese economy taking shape. Second, the Feds have started to reduce their quantitative easing as well as their activity of bond buying. Third, there remains an unprecedented number of long-term unemployed workers in the US who have likely been lost forever to the labour force. In fact, a record 92 million people are no longer counted as part of the US labour force.

Of course, all these negatives are irrelevant if US corporate earnings continue to grow at their current pace. For now, the stock market's collective price/earnings ratio is very close to its long-term median. That may bring comfort to some while others may argue that the market is priced for perfection. For this reason, we continue to believe that the best way to manage risk and return in this market environment is to stay long the market while protecting yourself and your portfolio with downside insurance where possible.

> *"Often we strive to strike a balance between the cost of the puts and the amount of volatility in the portfolio that we want to reduce."*

HOW TO INSURE YOUR STOCK PORTFOLIO

Generally for our non-registered accounts (ie. regular margin account) we like to buy portfolio insurance. We accomplish this by buying put options on the open stock market. Put options act as hedges in that their value increases when the stock market goes down. In a market downturn the paper gains from the put options help to offset the paper losses in the stock portfolio. Of course, if the market goes up, the put options go down in value and the paper losses on the puts partially offset some of the gains in the stock portfolio. Still, an investor who protects himself or herself by purchasing puts will almost always want the market to go up. It is the equivalent of life insurance in that you hope your policy never kicks in and the money spent on the insurance turns out to be a waste.

Just as insurance expires and has to be renewed every year, so too do put options. Investors can choose to protect/insure their portfolios for any number of time durations be it one week, one month, two months, three months, a year, or even longer. At Frontwater, we often buy puts on the index that expire within 30-60 days. When the puts expire, it gives us flexibility to reassess where we want to set the next level of insurance.

Finally, we should state that we rarely insure 100% of the portfolio. Often we strive to strike a balance between the cost of the puts and the amount of volatility in the portfolio that we want to reduce. Generally, we try to insure up to 30% of the portfolio at any given time thereby reducing volatility by an equivalent amount. FLT

CANADA'S TELECOM OLIGOPOLY:

"IF YOU CAN'T BEAT THEM, THEN JOIN THEM"

Today, three companies Bell, Telus, and Rogers dominate the sector while all outside competition has but washed away. With no outside threat to disrupt the oligopoly, expect Canadian consumers to continue to pay some of the highest cell phone rates in the world. What is bad for consumers is great for shareholders.

Five years ago, the story was shaping up differently. In order to break the Canadian telecom oligopoly, the Canadian Conservative government offered a range of financial incentives and preferential treatment to new entrants in the wireless industry. Three new telecom companies took shape: Wind Mobile, Mobilicity, and Public Mobile; and all offered mobile rates at substantially lower prices than the Big 3. Despite offering monthly plans at a significant price discount, these new entrants faced an uphill battle in attracting the Canadian consumer.

First and foremost, many consumers were locked into 3 year cell phone contracts with expensive cancellation penalties. Even if a consumer wanted to switch, the penalty to cancel outweighed the benefit. Second, Apple's I-Phone was not compatible at all with any of the entrants wireless technology. I-Phone users had no choice but to keep their contracts with the Big 3.

Third, many of the new entrants' footprints were limited to certain 'zones' within Canada. For instance, Public Mobile's signal worked great so long as one stayed within the Greater Toronto area. Cross into possibly Vaughan or Newmarket and you likely encountered expensive roaming fees or possibly no signal at all. Meanwhile Wind Mobile had to spend close to a billion dollars over four years to expand its network to cities across Canada. Unfortunately, in the company's quest to become Canada's fourth major cell phone provider, Wind Mobile left itself with little financial capacity to upgrade its network and spectrum in 2014 falling further behind the competition in speed and accessibility.

The Big 3 companies also found innovative ways to fight off the competition. Who would have thought that giving the phone away for free while charging consumers a much higher monthly rate would be such a successful customer retention program? Likewise, bundling TV, Internet, and mobile into one package provided customers with convenience thereby making it difficult for customers to switch one service for another.

> *"...buy any one, buy any two, or buy all three for the portfolio..."*

Today, Mobilicity, Public Mobile, and Wind Mobile are all but dead. Technically, Mobilicity is in bankruptcy protection. Telus which eventually ended up purchasing Public Mobile told customers this week that they had to switch to Telus. And Vimpel, Wind Mobile's parent corporation, recently wrote off its entire investment in Wind indicating that the corporation was basically worthless.

Of Rogers, Telus, and Bell, our recommendation is to buy any one, buy any two, or buy all three for the portfolio — it really makes no difference. For the next seeable future these Canadian Telecom rock stars are unstoppable with no serious threat to their oligopoly business model. FLT

SHARE PRICE FUNDAMENTALS FOR THE BIG 3

	Share Price	P/E Ratio	Dividend Yield
Rogers (RCI.B)	$45.75	14.1	4.00%
Bell (BCE)	$47.57	18.6	5.20%
Telus (T)	$40.42	20.0	3.57%

STOCK COMPARATIVE ANALYSIS:
MICROSOFT VS. FACEBOOK

Sometimes the fundamentals of sound investing are a fundamental paradox.

As discussed in our Q3 2013 newsletter, companies that have a proven track record of growth are attractive to investors. Consequently, they tend to trade at **elevated P/E multiples** because people are willing to pay a premium for the promise of continued growth. Companies that have seemingly hit the boundaries of their growth potential may be steady and dependable, but without the incentive of big gains in the growth department, they usually trade **at lower multiples.**

This is where the seeming paradox comes in. Take the case of Microsoft (MSFT) and Facebook (FB), which I spoke of previously back on September 30, 2013:

- MSFT traded at $33 with a forward P/E of 13
- FB traded at $50 with a forward P/E of 50

Fast-forward 6 months to March 31, 2014:

- MSFT trades at $40 with a forward P/E of 13.5
- FB trades at $60 with a forward P/E of 36

Both companies garnered a return of greater than 20% for their investors over that six-month period. One is a steady-as-she-goes, grey flannel suit behemoth with a low P/E ratio while the other is a petulant teenage upstart with a pierced nose and torn blue jeans, a high P/E ratio, and a future outlook of growth..

While Facebook's share price jumped by 20% over the two quarters, its earnings per share grew 66% - that's a lot of growth. And because of the strong earnings, the P/E ratio dropped from 50 to a very reasonable 36 in spite of the share price going up as well.

Now, in the case of Microsoft the stock also went up 20%... but unlike Facebook whose P/E multiple moderated, Microsoft's stock became more expensive as the P/E increased by a few points. MSFT's earnings were strong and steady, but not nearly as impressive as FB.

So, let's review:

- Facebook investors made 20% on their money after the company increased its earnings by 66%
- Microsoft investors made 20% on their money even though earnings increased by about 15%

Without a doubt, the market works in strange and mysterious ways. Well, maybe it's not really all that mysterious. MSFT is a consistent dividend paying company whose appeal has changed from growth to value and income. In fact, we would now classify MSFT as a dividend champion having raised the dividend every year over the last 10 years with one exception in 2010. A goose that cranks out a golden egg like clockwork every quarter is a lucrative bird. And don't forget, MSFT is poised by its very nature to become the beneficiary of any number of technological advances that could be thrust upon us just as suddenly and unexpectedly as the digital age. With a new CEO in place, MSFT has put cloud computing front and centre while XBOX One gaming continues to make strides in the entertainment gaming industry.

FB is a horse of a different color. It's still new and shiny, even though the days of "get

in and get rich" are moderating as it nears saturation. The company is proving itself with increasing and formidable earnings power as well as making a couple of billion dollar acquisitions over the last few months.

As for which of these two winners Frontwater Capital favors, we have historically owned MSFT while shying away from FB. True there is room for both companies in one's portfolio; we just felt MSFT was the better fit with our general investment objectives and risk tolerance levels for our client base.

We like the near 3% dividend yield. We like the trend of dividend increases. We like the inexpensive P/E ratio. And we like the fact that there continues to be new technology opportunities such as cloud computing, gaming, and data warehousing, for this company to grow further into. While our target total return for Microsoft is in the 8-10% range, the company has actually been averaging closer to a 15% total return over the last few years.

That's not to say that there is anything wrong with Facebook – after all, shareholders have done quite well owning Facebook. It is more a question of risk. When a company trades at fairly high P/E multiples, only a small glitch needs to happen to derail earnings. It's also a question of shelf life. Whenever I am tempted to put my whole roll of speculative slot machine quarters into Facebook, I just close my eyes and repeat three times: "MySpace, MySpace, MySpace." MySpace was never traded publicly, but they had hundreds of millions of members and once owned the turf that Facebook now controls.

Still, a few more years of staying power, strong earnings, and a falling P/E ratio, and FB may start to fall into our guidelines.

In this day and age where investors are looking for portfolio managers to manage the volatility, Microsoft gives your portfolio an established, dependable, lower growth tech company with an attractive dividend yield. FLT

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.

SERVICES

- Managing Investments
- Assessing your Risk and Investment Profile
- Designing your Asset Allocation
- Customizing a Financial Strategy
- Retirement and Tax Planning Considerations
- Structuring of Family Wealth
- Estate Planning
- Business Continuation Planning
- Protecting US$ Investments against Currency Risks
- Hedging against Extreme Events

PRODUCTS

- Equities
- Bonds
- Income Trusts
- Initial Public Offerings (IPOs), new issues
- Derivatives (Calls, Puts, Futures)
- Commodities
- FX Trading
- Insurance
- Alternative Assets
- Structured Products
- Closed End Funds

ACCOUNT TYPES

- Cdn$ and US$ cash and margin accounts
- RRSPs, RESPs, RRIFs
- Tax Free Savings Accounts (TFSAs)
- Individual Pension Plans (IPPs)
- Locked-In Retirement Plans (LIRAs)
- Corporate Accounts
- Small and Medium Sized Businesses
- Holding Companies
- Trusts
- Endowments

Guaranteed Investment Certificates (GICs)

WHY INVEST IN GICS?

GICs are secure investments that guarantee your initial principal investment, while earning a fixed rate of interest over their lifetime. GICs offer predictable income and are the foundation of many balanced portfolios.

HIGHER RATES, SAME RISK

As a deposit broker representing over 30 financial institutions across Canada, we are able to offer our clients personalized service at a lower cost. This means that the savings get passed along to you through higher interest rates with the same principal guarantee that all GICs provide.

BENEFITS OF OUR GICS:

In addition to offering CDIC protected GICs which provide protection up to $100,000, we also offer GICs with:

- UNLIMITED deposit insurance protection by:
  - ✔ CUDIC of British Columbia
  - ✔ Deposit Guarantee Corp. of Manitoba
  - ✔ CUDGC of Alberta
- 1%-1.5% higher than average rates (see table*) from over 30 Canadian institutions

	ANNUAL PAY	MONTHLY PAY	RRSP	RRIF	TFSA
1yr GIC	2.15%	1.90%	2.15%	2.15%	2.15%
2yr GIC	2.20%	2.00%	2.20%	2.20%	2.20%
3yr GIC	2.25%	2.15%	2.25%	2.25%	2.25%
4yr GIC	2.50%	2.30%	2.50%	2.35%	2.35%
5yr GIC	2.75%	2.45%	2.75%	2.70%	2.70%

*rates subject to change

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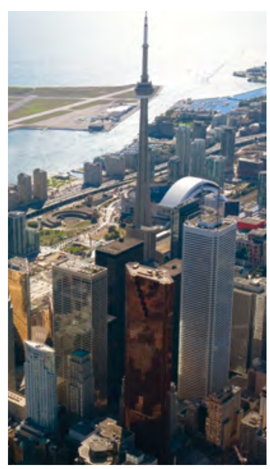

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