# Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | OCTOBER 2, 2016



WRITTEN AND PRODUCED BY

FRONTWATER CAPITAL


## Be Wary of Soothsayers, Pundits, and Market Forecasts!

At the end of Q2, the pundits told us that Britain was on the verge of economic collapse and the world would fall apart on the heels of a Brexit 'no' vote. At first, it looked like these market experts might be right and the bears might have their day in the sun. Then the opposite happened. After The U.K. referendum sent the Dow plummeting nearly 900 points over two days, stock markets soared. ***Turns out that the expert analysts were wrong.***

Fortunately, Frontwater knows market forecasts are about as accurate as the meterologist predicting the weather ten days out. Brexit turned out to be a fantastic buy opportunity and all our investors were rewarded with portfolio returns that well exceeded the market averages.

This past summer was record-breaking in two ways. Not only did the S&P 500 set new highs but volatility dropped to unprecedented lows. Stock market volatility was practically non-existent as the S&P 500 went an amazing 52 consecutive days without a 1% change in value in any direction – an incredible feat. So what did the experts get wrong?

Relative valuation is what makes stocks attractive even as average prices approach the historical end of the valuation spectrum. When 5-year German and Swiss bonds are paying negative yields, investors have little choice but to rotate out of bonds and into stocks. And because robust evidence shows investors tend to act as a group, pursuing similar strategies at the same time — they buy together and sell together — it has the added effect of pushing prices up.

Yes, it is true that the stock markets are starting to look expensive in this slow growth environment. The S&P 500 is currently trading at more than 17 times forward earnings estimates, near its loftiest level of the past seven years. But stocks are nowhere near as expensive as bonds as interest rates continue to hover at ultra-low levels.

Admittedly, our biggest concern right now is the absence of market volatility for such an extended period. Historically, that has never ended well and it's generally a sign of investor complacency. For those accounts in positive cash positions, we have made a conscious decision to stay patient and continue to let cash build up until volatility returns in the marketplace. For non-registered accounts, layering on cheap portfolio insurance is a no brainer.

More important than market forecast is Warren Buffett's principle of "be greedy when others are fearful and fearful when others are greedy." In this investor-friendly market and as the American population becomes more nervous with a possible Trump victory, we think it better to be prudent and cautious. It may yet take a month or two or more before volatility rears its head, but it's hard to believe investors won't see lower prices even if it is for a very short window of opportunity. After taking advantage of the recent run-up in prices this past quarter, sitting back and waiting for the "gunpowder to dry" is a welcome change of tactics.

*Why Protecting Portfolios Make Sense:*

# The Key To Hedging

**In the markets as in life, there are often "known unknowns". A "known unknown" happens when we know when an event is going to occur; we just don't know what the result will be. The upcoming US election is a perfect example. We know the election will take place on Tuesday, November 8th. We just don't know if the winner's last name is Clinton or Trump. Fortunately, it is possible to hedge against a "known unknown" event in a cost effective manner using put options.**

A put option is akin to insuring your portfolio for a specified period of time. That time period might be a week, a month, a quarter, or longer. In theory, one could maintain a constant state of insurance using puts, thereby protecting the portfolio against all possible adverse events. Practically speaking however, that would be totally cost prohibitive. So being prudent and picking your spots are key for any successful hedging program.

In today's relative calm and complacent market, put protection makes a lot of sense. As with life insurance, it's all about timing. The best time to buy life insurance is right after the doctor just cleared you for a clean bill of health – not after you have been diagnosed with a life threatening medical condition.

The same applies for put protection. The best time to buy puts (ie. Portfolio insurance) is when volatility is at its lowest and market sentiment is at its highest, and not the other way around. Buying put protection after volatility has spiked is already a day late and a dollar short.

Volatility as measured by the VIX is currently near its 52 week low at 13%. For comparison purposes and to put the VIX into perspective, the VIX jumped to over 26% in the week after Brexit. The 52 week high actually occurred in early February when the VIX touched 32%.

Credit spreads are equally important as the VIX when it comes to measuring market sentiment. A credit spread is the difference in yield between two bonds of similar maturity but different credit quality. For example, if the 10-year Treasury note is trading at a yield of 2% and a 10-year corporate bond is trading at a yield of 3%, the corporate bond is said to offer a 100-basis-point spread over the Treasury.

When both the VIX is low and credit spreads are narrowing, it is a strong indication of two things. (1) It shows that investors are willing to accept a lower risk premium for their investments; (2) it shows investors are more risk seeking. Vice versa, if credit spreads are widening it's a sign of economic trouble as investors become more risk averse.

Ideally, an investor wants to layer on put protection when credit spreads are narrowing as they are today. The current spread between high yield bonds and treasuries is only 417 basis points. This is an incredibly tight spread so much so that the high yield credit spread itself is close to its 52 week low.

The unrealized danger with a smug market is that not a lot needs to happen to unnerve investors. Take the US elections, it is not exactly clear how the markets will react to a Donald Trump victory. Hopefully, it will be 'steady as she goes', but layering on November put options that expire after the election on November 17th protects us from this one off event. It also gives us a lot more comfort and a lot more breathing room to finesse the portfolios as we see fit.



# CELGENE: A Well-Run Company In An Unloved Sector

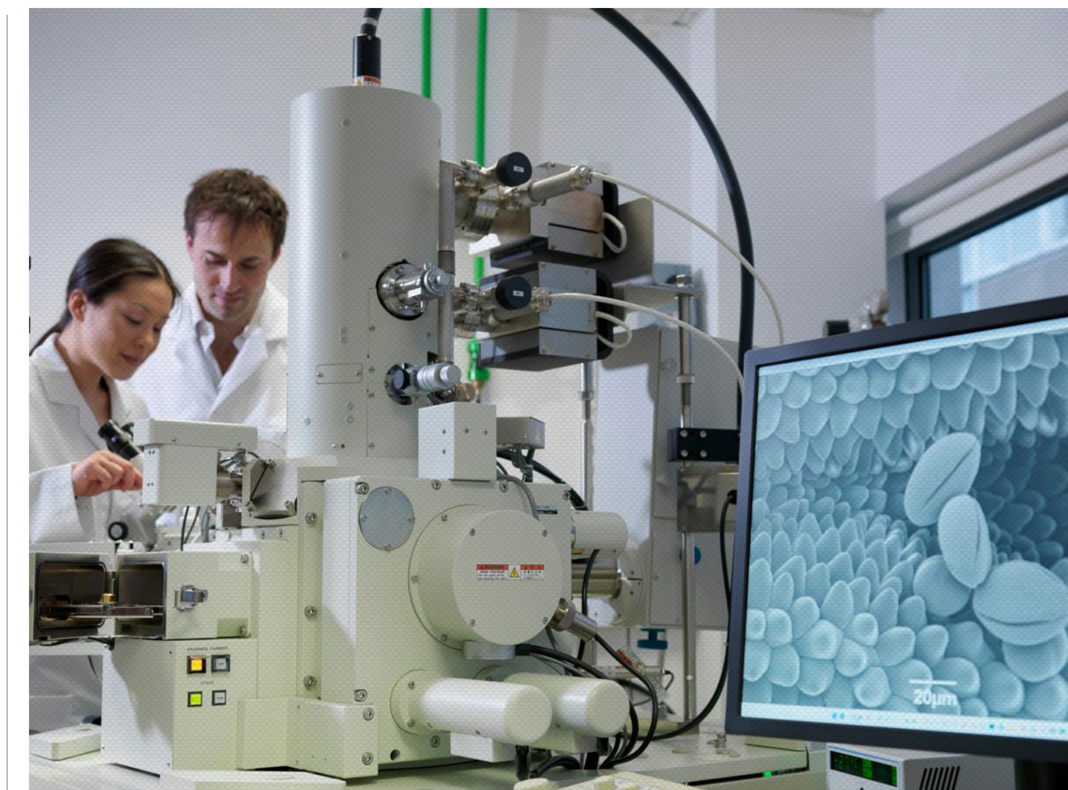
**It's no wonder healthcare and pharmaceutical shares have come under pressure for their despicable and immoral business practices. Just this past quarter, Mylan raised prices on EpiPens to $500 US. Ten years ago, those same pens were $57 US.**

Other drug companies like Valeant and Concordia Health have yet to be formally charged but their underhanded practices of excessive price increases puts them on par with Bernie Madoff in terms of ethics and corporate governance. Make no mistake, capitalism is never good when a small group of entitled people enrich themselves to the detriment of society and at the expense of the general population.

Still, good healthcare companies that actually improve quality of life do indeed exist. We believe Celgene is one of them. Celgene is a global biopharmaceutical company engaged in the discovery and commercialization of innovative therapies for the treatment of cancer and inflammatory diseases. With U.S. healthcare shares looking cheap and falling out of favour, there is a lot to like about Celgene.

Celgene has massive growth appeal thanks to a blockbuster blood cancer drug and one of the most extensive Phase III trial pipelines in the industry. The best thing about the company is that there is no price gouging; sales are mostly volume-driven for each of their flagship products.

Four products generate most of the company's revenues. Revlimid (used to treat blood disorders) is the dominant one making up 60% of revenues. The other products are Abraxane – used to treat breast cancer; Pomalyst – used to treat patients with multiple myeloma; and Otezla used to rheumatoid arthritis.



Pomalyst and Otezla in particular have experienced tremendous sales growth in the last year - 35% for Pomalyst and 170% for Otezla. Both drugs were only recently approved by the FDA and therefore have substantial upside revenue growth.

Over the last five years, Celgene's sales have increased by more than 150% and the company is on track to make $5 a share this year. Analysts estimate that Celgene will deliver between $11 and $12 by 2020. Applying a conservative 14 times price earnings multiple, and the stock could easily trade between $154 and $168 in 2020. That price level represents an approximate 15% annualized return..

**CELGENE (CELG) $104.53 USD AS OF SEPT. 30, 2016**

We actually think the potential for stock appreciation is even greater. Management is taking advantage of their financial prowess to invest further in product development. Celgene has 18 products in Phase III trials that are scheduled to deliver trial results between the years 2016-2018. Moreover the company has a profit margin of 19% and a return of equity greater than 32%. The twelve month forward price earnings ratio sits at a respectable 14 times. One would be hard pressed to find numbers like these on another company with a similar track record to

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# 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 (Offered thru WDBA and Associates)
- Alternative Assets

### 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

# CELGENE

CONTINUED FROM PAGE 3

Celgene. But because of recent turmoil in the industry, many investors are shying away from the pharmaceutical sector.

Likewise, capital allocation is solid and debt-to-equity ratios are reasonable. With a market cap of $87 billion and strong free cash, Celgene is more than capable of servicing its $14 billion of debt. And while the company does not pay a dividend, it bought back some $3.3 billion of its own stock last year and is looking to buy back another $4 billion.

The biggest negative on Celgene is the industry it operates in. Hilary Clinton has made it crystal clear that she will be targeting healthcare and pharmaceutical companies if elected. Who can blame her? The aging American population grows tire of the shenanigans and skyrocketing healthcare costs. But for those investors who can look past much of the criticism and rhetoric, Celgene offers tremendous value even under a steady-as-she-goes type scenario. It is much easier to come to grips with a company in an unloved sector than an unloved company in a favourable sector.

# 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.[1] 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 [2]

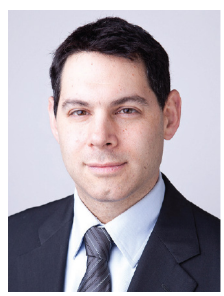
| | ANNUAL PAY | RRSP | RRIF | TFSA |
|---|---|---|---|---|
| 1yr GIC | 1.85% | 1.70% | 1.70% | 1.70% |
| 2yr GIC | 2.05% | 1.90% | 1.90% | 1.90% |
| 3yr GIC | 2.19% | 1.95% | 1.95% | 1.95% |
| 4yr GIC | 2.22% | 2.05% | 2.05% | 2.05% |
| 5yr GIC | 2.35% | 2.35% | 2.35% | 2.20% |

* Rates subject to change

[1] Frontwater does not issue GICs. GICs are issued through independent, third-party financial institutions.

[2] Based on comparable posted rates as of Sept 30, 2016 at Canada's five largest financial institutions.

**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.

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