

Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | OCTOBER 1, 2017

Loonie Bin

The loonie has been flying high! Good fundamental results from the Bank of Canada combined with the relative loss of trust in US politics have enabled the loonie to shine on the global foreign exchange podium.

The Canadian economy has consistently beaten analysts' expectations in 2017, most recently by recording growth of 4.5 per cent between April and June of this year - far above the consensus forecast of 3.7 per cent. Higher commodities prices are contributing to export gains, while a healthy job market is underpinning household spending. In August, the unemployment rate dropped to its lowest level in nine years.

Meanwhile, The Organization for Economic Co-operation and Development (OECD) has raised its expectations for economic growth in Canada this year as part of its interim outlook on the global economy. The economic think tank now expects the Canadian economy to grow by 3.2 per cent this year, outperforming every other country in the G7 group of advanced economies (i.e. France, Germany, Italy, Japan, the U.K., and the U.S.).

In July, the Canadian dollar crossed the 80-cent threshold for the first time in two years. By September, it had touched a high of 82.9 cents, capping off a record run, the likes of which have not been seen since 2003.

All good? Not so fast. Every silver lining has its dark cloud. The good news about the loonie is as much related to image as substance. Relativity is an important factor in the perception of value.

For starters, much of the loonie's recent rise is due to the comparative fall of the US dollar. President Trump's continuing outbursts have given the US an image problem. Trading insults with North Korea and condemning NFL football players protesting the national anthem are only the latest in a series of tweets, official statements, and off-the cuff remarks that often leaves a wide-eyed world scratching its head. As a result, all



world currencies, and not just the loonie, have appreciated against the US dollar.

But a cheap US dollar is a double-edged sword. So is an expensive loonie. Our dollar goes a little further when we cross the border and buy goods in the US, but American goods are much more competitive relative to Canadian manufacturers on the world market. It's much harder for Canadians to compete with our 80 cent dollar than a 72 cent one.

Moreover, buried in Statistics Canada's latest job report is a troubling little tidbit. Wages are relatively flat, up just 1.0 per cent over the past year. With inflation

at 1.3 per cent over that same period, real wages in Canada, adjusted for inflation, have actually fallen by 0.3 per cent. Negative wage growth is subsequently forcing Canadians to take on more debt, a reality that may be sending Canadian households into an endless debt cycle.

And the dominoes keep falling. Weak wage growth means youth have become more dependent on their parents, who are taking on more debt to finance their children's education or the purchase of a first home. Seniors are among the fastest-growing non-mortgage debt burdens in the country.

Likewise, if one takes a deeper look into

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COMUGNERO SILVANA - FOTOLIA

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“TOO BIG TO JAIL”: HOW TO PROFIT FROM COMPANIES THAT BEHAVE BADLY

Fake accounts at Wells Fargo; bribery scandals at SNC Lavalin, corrupt accounting practices at Home Capital and most recently data breaches at Equifax are but a few examples of companies with top brass scandals and major legal woes. It turns out that bad behaviour is rarely, if ever, a death sentence.



Yes, rogue employees and corrupt management teams can knock a company out of favour, but big cap companies with thousands of employees are simply “Too Big To Jail”.

In each of the above situations, share prices went drastically down – in some cases by more than 50%. At some point on the downswing, each of these companies represented fantastic ‘buy’ opportunities.

Law enforcement officials and security regulators have their hands tied when it comes to laying punishment on the doorstep of the corporation. No one wants to see thousands of innocent employees displaced or let go because regulators go after the company as a whole.

The board of directors clears out a few bodies and sacrificial lambs, and the company makes the argument that the shenanigans have been contained and the cancer expelled. Surely, it is now unfair to punish hundreds or thousands of employees with job losses because of a rogue few. In almost every case, government officials back off once the CEO ‘resigns’. The corporation is then handed the equivalent of a parking ticket as a fine.

Now, none of us here at Frontwater would ever condone bad behavior from bottom-feeding corporate moguls. But common sense dictates that we dispassionately identify companies that are out of favour. If the opposing goalie gets injured and the refs don’t blow the whistle, you take the shot. In other words, if you see an opportunity, seize it. Sound investing is about

sniffing out a healthy return on your investment. We want to buy low and sell high. In the numbers game of high finance, it really makes little difference if the stock price takes a dive because of trade policy with America, its dependency on government subsidies, or because an unscrupulous CEO had some dirty dealings.

Go ahead – grab a piece of the action as the stock price dips on a period of desperation and uncertainty. Admittedly, it is not easy to pick the perfect entry point when the share price is plunging. So buy a little at a time. If the share price continues to decline, don’t be afraid to buy more. If you see an uptick in the share price because of a CEO resignation, don’t be afraid to buy more. That’s dollar-cost averaging at work.

Executives come and executives go, but a company with a solid business is around for the long term. And when companies with a healthy core and a viable business model become bargains due to a momentary lapse of reason, we become very interested. Legal turmoil and the tumult of scandal can give a company a black eye, but black eyes heal. For better or worse, investing in wrist-slapped institutions can offer great upside.

Wells Fargo: “Eight is Great”

Wells Fargo CEO John Stumpf was known to have heavily pushed his mantra of “eight is great” to lower level employees. Employees were tasked with getting eight Wells Fargo products into the hands of each

customer – an aggressive if not an unreasonable sales target. Struggling to meet demanding quotas and satisfying their demanding regional VPs, these lower level employees opened deposit accounts and credit cards for 3.5 million customers without their knowledge or permission.

What was the consequence of a such action? Sure, the SEC started investigations and eventually fined the company \$185 million. But the overall aftermath was nothing close to justice. CEO John Stumpf was forced to resign with a \$133 million USD package! The rest of management, save 4 regional executives, was off the hook. Meanwhile 5,000 low-end bank employees lost their jobs with nowhere near the severance of their CEO.

Home Capital: It’s the Weather!

Home Capital Group knowingly misled their shareholders by trying to sweep fraudulent mortgage origination business under the rug. Basically, Home Capital does a tremendous amount of business with third party mortgage brokers. Rather than come clean to shareholders about an internal investigation that revealed some shady business practices on \$881 million worth of loans (roughly 10 per cent of its originations), the CEO and CFO falsified their financial statements and blamed the ‘weather’ for poor earnings.

At first, lawyers from the Ontario Securities Commission pressed the company hard and rightfully so. But once, investors

started pulling their GICs and deposits out of the company, regulators began to worry about a ‘run on the bank’ and its domino effects on the Canadian banking industry as a whole.

As we all know, Warren Buffet swooped in on the 11th hour and bought shares in the company. Home Capital’s CEO and founder, Gerald Soloway was shown the door as part of the company’s settlement with the OSC. Otherwise, the company seems as though it will survive, and there has been minimal further impact to its employees.

SNC Lavalin: The Rogue Executive

When it comes to SNC Lavalin, the Montreal-based company has never been short of scandals in the last two decades. Bribery overseas has predominantly placed SNC on the headlines. Ben Aissa was an executive overseeing the international global construction division. He established two shell companies whose sole purpose was to transfer funds to different ‘groups’ within the Middle East, Libya in particular. Eventually, SNC fired its CEO after he was apprehended and charged by the RCMP. There was some concern that SNC might not be able to bid on government jobs due to its participation in bribing foreign officials; in the end, it remains “business as usual”. The firm is free to bid on all government projects and the company has supposedly turned over a new leaf with new leadership, and mandatory ethics testing.

EQUIFAX

THESE ARE THE VOYAGES...

For many, it was that shiny brass model of the Star Ship Enterprise in the store window that was looked upon enviously and yearned to own. For others, and perhaps later in life, it was that pair of diamond-studded Jimmy Choo pumps that could turn you into a dancing princess. And for us stock market junkies, Equifax has been that elusive butterfly that always captured our eye and attention; alas as frugal investors, we could never bring ourselves to pay the premium to own...UNTIL NOW:

Forever, we watched and waited; years went by. So when the stock tanked 45% due to a data breach in mid-September, we jumped on this once-in-a-decade opportunity. There are few industries that are as bullet proof as consumer credit reporting agencies. With only three major players, this is your all-star oligopoly of slow and steady long-run performance beaters.

The credit reporting agencies (CRAs), also known as credit bureaus, compile details about your credit history so potential lenders can assess your risk profile when granting a new credit card, loan, or mortgage. Financial institutions need credit reporting agencies. There is simply no way of eliminating this middle man. Without credit scores, the world of financial institutions and lending stops spinning.

But the show must go on – even when the actors are fools.

The three players that dominate this space are Experian, Equifax, and TransUnion. Experian is the largest with a market cap of \$18 billion USD. Equifax, founded in 1899, is the oldest of the three with a market cap of \$14 billion USD. And TransUnion is the smallest with a market of cap of \$8.5 billion USD.

Equifax recently had the dubious honour of making a splash in the headlines for a huge cyber security breach. Hackers exposed the Social Security numbers and other highly sensitive information of 143 million Americans. That, in and of itself, was a major blunder. But the Comedy of Errors theatrical disaster that followed was even more ham-handed, inelegant, and just plain inept.

In Act One, Equifax took more than a month to notify the public about its data breach. The breach



TICKER: EFX PRICE: \$105.99 USD AS OF SEPTEMBER 29, 2017

itself happened on May 13th, and Equifax discovered the problem on July 29th. But it took the company until September 7th to go public with the news. The stage was set for drama and intrigue.

Enter the Three Stooges: On August 2nd, Chief Financial Officer John Gamble sold shares worth \$946,374 (13% of his stake in Equifax), Joseph Loughran, president of U.S. information solutions, exercised options to dispose of stock worth \$584,099 (9% of his stake in Equifax), and Rodolfo Ploder, president of workforce solutions, sold \$250,458 of his stock (4% of his stake in Equifax). A little suspicious by most people’s standards.

Even the Intermission was fraught with bumbling incompetence. Equifax directed consumers to a new web site to find out if their personal information had been compromised. But consumers who signed up at the website encountered a multi-step process that never led to a definitive answer such as: “Based on the information provided, we believe that your personal information may have been impacted by this incident.” The flashing lights sent them back to the auditorium for the Final Act.

The Grande Finale, and the real icing on the cake was when Equifax actually attempted to profit from its own screw-up. Equifax was more than willing to let consumers lock their credit report for free. But if you wanted to unlock your accounts, you had to pay a fee between \$5 and \$10.

Without a doubt, Equifax messed up badly. The play was

a flop, and bad reviews ensued. But you don’t burn down the theatre because of one bad show and investors shouldn’t throw away 118 years of history because of one bad incident and a few rotten apples.

Let’s remember that this is a company with extremely healthy profit margins greater than 17%. Return of equity is greater than 20%, and the forward price earnings ratio at 18 is very reasonable for a company that grows its earnings at a 20% clip. Sounds like good value on all fronts.

The stock hit an intraday low of \$89.59 on September 15th, 2017 and started to flat line between \$92 and \$94. We began acquiring shares about a week later at a slightly higher price point of \$96. And we continued to build that position as the share price increased with each passing day. By the end of the quarter, Equifax’s share price closed out September at a penny under \$106. And even at today’s level, we still believe there is good value to be had!

In many ways, the breach at Equifax reminds us of similar legal issues that the credit rating agencies went through post 2008. Both Moody’s and S&P Credit Ratings are stronger than ever before. With limited options and limited competition, we expect Equifax to be around for a very long time. With a little luck and a lot of lithium crystals, we believe this company will navigate its way out of its current troubles – if not to ‘where no portfolio has gone before’ then at least to a better place.



IMAGE: CNBC

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, RRIIFs
- 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



LOONIE BIN

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the employment data, one can find some troubling data. Vast numbers of Canadians have had to take part-time jobs, since they couldn't find a full time opportunity. That is not sustainable job creation. True, the jobless rate fell to 6.5 per cent in June, from around 7 per cent at the start of 2016. But the vast majority of the 45,300 jobs added in June were part-time.

Finally, the Bank of Canada has cited solid and broad-based growth in its decision to start lifting interest rates from historic lows. Canada's central bank raised rates twice this summer, doubling the interest rate from 0.5 per cent to 1 per cent. Higher interest rates have a cooling effect on growth, while helping to keep inflation in check.

For now, it looks like the Bank of Canada will hold rates at their current level, but they have gone on record saying that they are prepared to pull the trigger again if the Canadian economy continues to show traction.

Overall, the faith of the Canadian dollar is still murky. Canada is still very much a resource-based economy, and with oil prices contained in the \$45 - \$55 range, it is hard to foresee a catalyst for further growth. Yes, our US cousins have an image problem but with US GDP expected to rise to over 3% and a possible tax package in the offing, things could turn on a dime for the US currency. In the absence of a commodity sector rebound, all signals point to the loonie settling back into the 75-78 cent range by Q1 2018.

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 institutions²

	ANNUAL PAY	RRSP	RRIF	TFSA
1yr GIC	2.27%	2.20%	2.20%	2.20%
2yr GIC	2.42%	2.30%	2.30%	2.30%
3yr GIC	2.41%	2.35%	2.35%	2.35%
4yr GIC	2.46%	2.45%	2.45%	2.45%
5yr GIC	2.66%	2.60%	2.60%	2.60%

* 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 September 30, 2017 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.

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



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