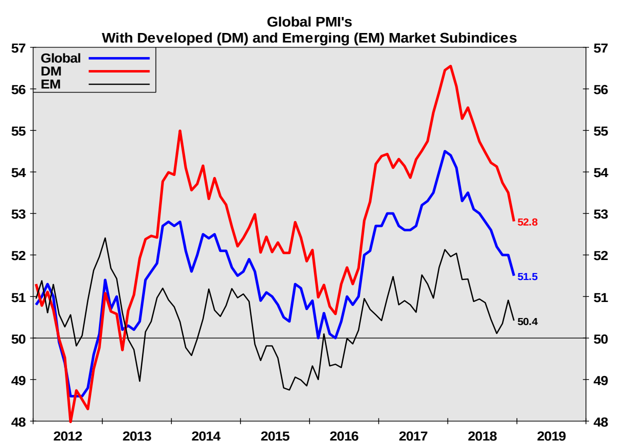
What Just Happened In The Stock Market?

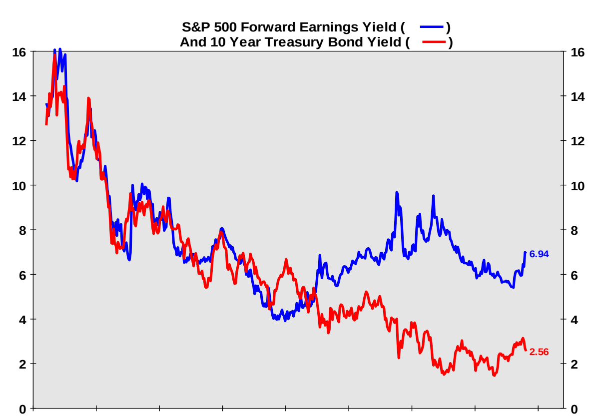
In the midst of extreme market volatility, we thought the above title, borrowed from Cam Hui a well-regarded macro strategist, to be apt. The ferocity of the late quarter equity market sell-off seemed to materialize from nowhere and to derive mostly from the simple phrase “on auto pilot”. These were the words that Jerome Powell, Federal Reserve Chairman used to describe the process of normalizing the Central Bank’s balance sheet. They were interpreted as being rigid with little regard for the changing economic environment. This combined with slowing growth rates in Europe and China as well as the potential of a worsening situation in the United States vs China trade negotiations, led to an explosive atmosphere. The resultant uncertainty fed a change in sentiment that was both extreme and not supported by company fundamentals. Hedge funds, ETF’s and algorithm-driven short-term investors who have increasingly come to dominate equity trading, reacted predictably, adding to the volatility. Subsequently the Fed has recently clarified its intentions, emphasizing a flexible policy that will be responsive to changing economic circumstances.

There are many legitimate concerns, which we will try to address in this letter. Trade negotiations and reliable economic statistics on Chinese growth are almost impossible to accurately assess and are inherently short-term in nature. As fundamental research-driven investors, we will carefully follow the prospects for our investee companies and initiate buy and sell decisions based on company-specific factors and valuation.



Courtesy of TD Securities – Dec. 2018

Turning first to the overriding question of economic growth, the Purchasing Managers Indices in the table to the right graphically show slowing growth in all developed and developing economies. Causes include internal factors such as Brexit, the Italian budget deficit and of course the uncertainty created by the ongoing trade dispute between the United States and the rest of the world.



Courtesy of TD Securities – Jan. 2019

In spite of manifest domestic socio-political issues and slightly higher interest rates, American consumers have remained optimistic and the job market is the tightest it has been in five decades. GDP growth in the US will decline in comparison to the tax-cut assisted growth in 2018. Moderate growth (1.5-2.5%) will prevail in Canada and Europe. Most importantly, the Chinese economy, the growth engine for all of Southeast Asia, will likely expand at an annual rate of about 5%.

2018 was an historical anomaly, as most fixed income investments and virtually all world equity markets, provided an array of negative returns. There were few safe havens. Manitou’s conviction remains firm in the belief that over any reasonable time horizon, equity returns will exceed fixed income returns. In this regard, the chart on the left shows that a heathy risk premium still exists when comparing the yield on ten year treasuries with the forward earnings yield of the S&P 500.

This is a healthy premium that reflects concerns that the world's geo-political uncertainties (which are too numerous to discuss here) could negatively impact the global economy and by extension corporate earnings growth. While this may sound like a seemingly negative narrative, the table below hopefully gives rise to optimism.

As shown, after sharp market corrections, equity returns over the ensuing one and three-year time intervals are positive. This supports the adage: "you better have as much exposure on the way up as on the way down". Moreover, the way up is more certain if one's exposure is to financially sound free cash flow generators.

		Forward Performance		
Quarter Ending	Performance	1-Year	3-Year	5-Year
June 30, 1962	-21%	27%	54%	66%
September 30, 1974	-26%	32%	52%	72%
December 31, 1987	-23%	12%	34%	76%
December 31, 2008	-23%	23%	39%	105%
AVG	**-23%**	**24%**	**45%**	**80%**

Data Source: S&P Global Market Intelligence; Interactive Data Pricing and Reference Data LLC

Free Cash Flow: The Ultimate Sleep at Night Factor

Regardless of bear markets or recessions, companies with strong free cash flow generation can maintain strong financial positions, making them unlikely to face bankruptcy and more likely to thrive over time. This aligns with our belief that investment risk is best defined in terms of the potential for a permanent impairment of capital rather than price volatility caused by short-term factors or sentiment.

As anyone familiar with Manitou knows, free cash flow is central to our assessment of the quality of a business. It is arguably the primary driver to achieving a strong balance sheet, our top criteria for business quality. In addition to using free cash flow as a determinant of quality, we forecast future free cash flow as part of our valuation process. Other inputs such as a discount rate (higher is more conservative) and growth are superfluous if a business' ability to generate cash is compromised.

EBITDA (earnings before interest, taxes, depreciation and amortization) is a widely used industry substitute for cash flow. We do not use this measure of profitability because it excludes the true costs of replacing depreciated assets. At the end of the day, we want to be able to differentiate between the cash flow necessary to maintain a business' ongoing operations (i.e. cash to replace depleted assets) and the discretionary cash flow that is 'free' to fund such uses as business expansion, acquisitions, dividends and stock buybacks.

Assuming mandatory obligations are being met, the best evidence of free cash flow generation is seeing it accumulate on a company's balance sheet. This is currently the case at Constellation Software and Enghouse Systems. Interestingly, coincident with their cash balances increasing their stock prices have fallen. We suspect this reflects investors' concerns that slowing M&A activity will negatively impact their growth rates. While this may be the case in the short-term, we are confident that both companies have moderated their deployment of free cash flow awaiting better long-term investment opportunities based on management's disciplined acquisition criteria.

In the case of LVMH, it will generate approximately €5.5 billion of free cash flow in the upcoming fiscal year. This supports its ability to fund value-creating investments such as the recently announced US $3.2 billion purchase of the Belmond luxury travel portfolio.

Despite recently depressed oil prices, the cash flow profile of Canadian Natural Resources (CNQ) has materially improved since it completed the capital expenditure program to build out its Horizon oil sands project. Its free cash flow generation has also improved as a result of investments in technology that have lowered extraction costs.

Looking at Apple as another example, in 2018, its free cash flow generation was $59 billion versus $47 billion the previous year. Even if top line sales decline a few percentage points and margins remain roughly in line with the previous year, our outlook for this year points to free cash flow generation of approximately $55 billion. The free cash flow generated by both CNQ and Apple provides management with numerous options to enhance shareholder value and each is likely to pursue large buy-backs.

Regardless of market conditions and especially if we encounter conditions similar to 1962, 1974, 1987 and 2008, we sleep well at night knowing that the businesses we own have strong balance sheets and ample free cash flow to not just survive, but ultimately thrive.

Manitou Mandates

For Q4 2018, all Manitou Mandates achieved respectable results given the high volatility experienced by global markets. In all cases this is principally due to security selection. Global Equity returned -5.92% versus the benchmark of -8.21%, Manitou Equity (North America) -7.16% versus the benchmark of -9.36%, Canadian Equity -8.56% versus the benchmark of -10.11%, US Equity -5.85% versus the benchmark of -8.62%, Focus 5+ -3.14% versus the benchmark of -9.36%, International Equity -0.04% versus the benchmark of -8.09% and Income Fund +0.95% versus the benchmark of +1.43%. As mentioned last quarter, performance results of the Total Return Yield Fund (TRY) lag by one quarter. Accordingly, the results provided below are for the period ending September 30th, 2018.

The principal contributors to this quarter's returns in Manitou Global Equity were CME (+15.84%), LVMH (+8.74%), 3M (+8.05%), Jardine Strategic (+6.51%) and Diageo (+5.68%).

CME benefitted from record volume of energy-related futures and options.

LVMH outperformed sales and earnings expectations for the latest quarter.

3M's share price performed well as did many US industrial peers during the quarter as investors exhibited a "flight to quality" approach to counter-act market volatility.

Jardine Strategic outperformed after announcing the sale of Jardine Lloyd Thompson, a UK insurance brokerage firm to Marsh and McLennan.

Finally, Diageo is another example of "flight to quality". It is executing well on its portfolio strategy, disposing of several brands after having purchased Casamigos Tequila last year.

The detractors included Apache (-41.28%), Apple (-24.30%), and CNQ (-20.84%).

Both Apache and CNQ declined in line with oil prices, which many believe were influenced by factors such as rising US crude inventories, the likelihood of OPEC production cuts, waivers to Iran oil sanctions and declining demand in emerging markets as a result of the strength of the US dollar. In addition, the Canadian oil sands company CNQ continues to face difficulties in moving heavy crude resulting from pipeline delays.

Apple's share price declined reflecting its decision to discontinue providing disclosure with respect to iPhone unit sales. Instead, the company will report the dollar value for the segment going forward. Concern also remains regarding longer-term demand trends from China.

For Manitou Equity (North America) the principal contributors included CME (+18.33%), Alimentation Couche-Tard Inc. (+5.24%), Dentsply-Sirona (+4.12%) and Computer Modelling Group (+1.55%).

Couche-Tard's share price increased on the back of solid results, which beat consensus estimates.

Dentsply-Sirona increased on the release of the strategic review put forth by new management.

CMG increased on no firm-specific news.

All other companies have been previously mentioned.

The detractors included Apache (-41.32%), Apple (-25.78%), CNQ (-20.85%), IBM (-19.92%) and Enghouse (-18.88%).

IBM declined after announcing the acquisition of Red Hat at a significant premium. This is its largest deal to date.

Top performers in the Canadian Equity fund included Tucows (+13.85%), Thomson Reuters (+11.58%), and Alimentation Couche-Tard (+5.26%).

Tucows increased as a result of good operating results.

Thomson Reuters outperformed after announcing the divestment of Reuters, the Financial and Risk business.

Canadian Equity detractors included Suncor (-23.05%), Prairiesky Royalty (-21.07%), CNQ (-21.05%), Ensign Energy Services (-20.98%), and Computer Modelling Group (-19.24%). All companies mentioned above with the exception of CMG declined in line with the Canadian oil sector as a whole.

For the US Equity Mandate top performers included CME (+18.16%), Tucows (+13.53%), 3M (+8.16%) and Diageo (+5.51%).

All companies have been mentioned previously.

Bottom performers included Apache (-41.29%), Apple (-25.77%), IBM (-19.77%), Airbus (-19.50%), and Anheuser-Busch Inbev (-18.07%).

Airbus' share price declined after the announcement of an inquiry by the US Justice Department relating to government subsidies.

Anheuser-Busch Inbev declined post results. Management announced a dividend cut to reduce debt and strengthen the company's Balance Sheet.

F5+'s top contributors included Tucows (+13.53%) and Johnson & Johnson (+5.37%).

J&J's share price recovered, having previously declined on media reports pertaining to the talcum powder class action suit. No new information has been released and J&J has been found not guilty with respect to all accusations to date.

Detractors included Apache (-40.41%), Enghouse (-18.88%), Facebook (-12.10%), Constellation Software (-7.87%) and Whirlpool (-4.34%).

Both CSU and Enghouse declined because of lower than expected acquisition activity during the quarter. The companies have added to their cash reserves, further strengthening their balance sheets.

Facebook's share price declined as a result of continued media attention surrounding its risk management activities.

Whirlpool, as a US appliance manufacturer was negatively affected by US import tariffs on steel.

The International Fund's top performers were LVMH (+8.42%), Jardine Strategic (+6.58%), Diageo (+6.05%) and Novartis (+4.15%).

Novartis announced the sale of part of its Sandoz generics business to re-focus more heavily on pure pharmaceuticals.

Detractors included Anheuser-Busch Inbev (-19.15%), Richemont (-17.33%), Airbus (-19.26%), Spirax-Sarco (-11.20%) and Kingspan (-3.22%).

Richemont declined on demand fears from China, a significant geographic segment for the luxury watch and jewelry maker.

Spirax-Sarco suffered on no firm-specific news as did Kingspan.

The Income Fund underperformed its relative benchmark (+0.95% versus +1.43%). We continued to favour short duration bonds in a rising interest rate environment. The fund benefitted from the contribution of high yielding securities contained within its basket clause.

The Total Return Yield Fund (TRY) ended its first year with over $20MM under management, diversified across 16 strategies.

As mentioned previously, TRY is valued quarterly, however, given that many of the holdings in this mandate are not traded in the public market, the Fund's per unit price is not calculated until approximately twenty-five days after each calendar quarter end. The Fund's return to the end of Q3 was +5.16%.

The top contributor was TIMIA, a lender to rapidly growing subscription-oriented software businesses. Instead of taking equity positions in its investee companies TIMIA negotiates royalty streams tied to revenues. Timia's business model has performed exceedingly well, such that it has repaid most of our initial investment in addition to interest and bonus payments. Our confidence in TIMIA's management team as well as the industry in which they operate remains positive.

Double-digit interest was earned on TRY's largest positions, Easy Legal Debentures and a highly secured bridge loan to a private company.

Detractors included ARCH, which is a real estate company that specializes in upgrading and operating nursing homes outside of the GTA. Due to the change in government in Ontario, the process of licensing nursing homes stalled, which resulted in our Arch investment being held in short-term deposits while awaiting deployment. The situation has been rectified and we anticipate ARCH to begin generating higher returns starting in Q1/19.

The poorest performer was JPL's US High Yield/Distressed Debt mandate, which will post a negative return consistent with the sector as a whole. We understand the volatility inherent in this investment, and as such have made only a small allocation to this investment (currently less than 1% of the portfolio).

No stocks cited above were completely sold and we added to our positions opportunistically on share price weakness throughout the quarter.

Conclusion:

For the entirety of 2018, with the exception of the US Equity Mandate under-performing the S&P 500 by 21 basis points, all Manitou Mandates outperformed their respective relative benchmarks. While laudable on one hand, we are disappointed that all mandates underperformed our stated absolute benchmark of CPI + 7% (8.9% in 2018). The past year aside, we are undeterred in our goal of generating superior long-term results by adhering to our proven approach of concentrated investing in high quality companies at attractive prices.