Opportunities in Turbulent Times

A. Market Update – Second Quarter Review

After a volatile first quarter, equity markets within the developed economies experienced an improved second quarter, gaining back much of what they had lost in the first quarter. Gains were aided by economic data confirming that the US economy continues to grow at a solid clip. In fact, US retail sales grew by over 6% year-on-year in May and unemployment fell to 3.8% – the lowest level since 1969! The improvements in the US labour market are expected to continue into the second half of the year, with GDP topping 3%.

The strong US economy gave the Federal Reserve (Fed) the confidence to raise interest rates again in June, and signal two further hikes later this year. They also indicated that they expect three more rate hikes next year. While the US economy is relatively strong, compared to the rest of the world, it will be difficult for the Fed, to raise rates five more times, in the next 18 months, as a result, we remain skeptical and cautious. One thing is certain, the economic policies initiated by the Trump team (lower taxes, less regulations and the repatriation of oversees monies) are having a strong positive impact on the US economy.

In contrast to the US, there has been a string of disappointing economic data, including very low core inflation in the European Union (EU). Due to this data, the European Central Bank (ECB) has announced that interest rates will not be going up until at least the summer of next year, and their quantitative easing (printing money) would continue to the end of this year. In the UK, the Bank of England remains on hold in terms of interest rates, due to their concern with the potential impact of Brexit, on the capital markets and capital flows. With interest rates on hold in the EU and the UK, and on the rise in the US, it's not a surprise to see the US dollar continue to rise and the Euro and Pound weaken.

Interestingly, the recent weakness in the euro has not benefited European equities. Perhaps this is due to the fact that some of the embedded risk in the peripheral European countries is starting to percolate to the surface! Remember the PIIGS acronym from the 2010-2012 time frame? PIIGS stood for Portugal, Italy, Ireland, Greece and Spain. Other than Ireland, the four remaining countries are plagued with financial problems. The most acute issues facing these countries include their runaway debt, their massive unfunded pension and healthcare liabilities, and their aging populations. As we have pointed out many times, no families leads to no children, and no children equals no future! With family formations and child births throughout Europe at all-time lows the future is bleak.

Most recently, a sharp increase in Italian government borrowing costs, took place because of the change in government and concerns over their desire to leave the EU! For the time being, the spillover effect from Italy and the uncertainty in that country, has not impacted the rest of the European bond markets significantly. The Eurobarometer survey for March, for what it is worth, showed that support for the euro in Italy has actually risen, with only 29% in favour of leaving the euro, 61% in favour of staying and the rest unsure. If this is true, the risk of a broader systemic issue (financial crisis) for the European markets should be kicked into the future, although the debt and pension crisis throughout the EU will eventually lead to a major financial crisis at some point.

The US dollar has not just rallied against the euro this quarter, but against most currencies, and this has had important implications for equity markets. The British Pound's weakness against the dollar helped the FTSE 100 (filled with global companies), deliver strong returns in local currency terms, as foreign revenues (most in USD) are repatriated. In emerging markets, a stronger dollar is a headwind to equity performance, and that was the case this quarter and year-to-date. The worse performing equity markets in the world, so far this year, are the emerging markets, with many down as much as 10% year-to-date and the Chinese equity markets down around 15%.

The direction of the dollar will continue to be important for equity market performance going forward. Unfortunately it is very difficult to predict short-term moves in currency! As a result, we will continue to invest in what we know and understand, great businesses that make money all around the world, and therefore provide us with a natural currency hedge.

Trade concerns have also weighed on equity markets, with markets outside the US most affected. Trade concerns coming out of the US have dragged on Chinese and emerging market equities. European equities have also been affected, with auto companies suffering on fears that US tariffs could be applied to car imports from Europe. The conclusion to this fracas is hard to predict. We believe that the trade war is real and that the US will not back down, until significant concessions are made. The reality is that many of the current trading arrangements are not fair to the US and President Trump will not be easily swayed from his long-standing opinions on trade (Trump has been talking trade for over 30 years). There is no doubt, that the longer this drags on, the greater the risk that it starts to impact sentiment more broadly, and equity markets could come under greater selling pressure, providing greater opportunities to add to our favourite stocks!

In addition to trade concerns, the most vulnerable emerging markets, with large current account deficits (external funding requirements), such as Turkey and Argentina, have come under significant pressure, with sharp currency and equity market falls. Further US interest rate rises or dollar strength, could put additional pressure on the most vulnerable emerging market economies. This is why our focus remains on global firms that do business all around the world and are not dependent on vulnerable countries. Overall, growth still looks healthy and corporate earnings are growing strongly spurred on by last years' tax cuts in the US. Yes, there are a number of potential political and economic risks to the markets that will at some point raise their ugly heads, but we are best prepared for these events by owning a basket of exceptional companies and keeping a few dollars on the sidelines, ready to take advantage of any market turbulence!

North American Equity Market Statistics

During the second quarter and year-to-date, the Canadian equity market, S&P/TSX increased by approximately 5.9%, and .4% respectively. Over the last 12 months, the Canadian market advanced by 7.2%. The S&P/TSX, after being one of the worst performing equity markets in the developed world, (and still one of the worst over the past 10 years) advanced nicely in the second quarter. Despite the underperformance of the broad basket of Canadian equities, ROCKLINC has managed to generate solid returns, staying ahead of the overall market index by avoiding "almost all" of the weak performing stocks and minimizing our exposure to some of the underperforming sectors.

In the second quarter, only one sector in the S&P/TSX generated a negative rate of return! This was quite the reversal from the first quarter, when only one sector was positive in the quarter.

During the second quarter, only the utilities sector was negative with a total return of -1.6%. With interest rates edging up over the quarter, it is not a surprise that the utilities sector gave back some returns, given the sector's sensitivity to interest rates. For our investors, this downward pressure in equities was felt within our real estate (Choice Properties and First Capital) and infrastructure companies (Brookfield Infrastructure, Brookfield Renewable & American Water as examples). In the short run, the prices of these businesses are influenced heavily by the direction and rate of change in interest rates! In the medium to long run, their prices are determined by their growth and profitability, which in the case of our businesses, are chugging along very well!

In terms of the S&P/TSX, the sectors ranked from best performing sectors to the worst in the second quarter were: Energy +14.7, Healthcare +14.1, Information Technology +10.8%, Industrials +9.0%, Materials +7.5%, Consumer Discretionary +6.0%, Real Estate +3.5%, Consumer Staples +3.2%, Financials +1.0%, Telecom +.7%, and Utilities (-1.6%).

Pertinent market action during the second quarter of 2018 and during the last 12 months is captured in the following table.

	June 30, 2017	March 31, 2018	June 30, 2018	3 Month	1 Year Return
CAD/USD	$.7713	$0.7752	$0.7630	-1.57 %	-1.08%
Oil WTI (US $)	$46.04	$64.94	$74.13	+14%	+61%
Gold (US $)	$1,241.42	$1,325.47	$1,250.45	-5.7%	+.7 %
Silver (US $)	$16.59	$16.37	$16.06	-1.9%	-3.2%
S&P/TSX	15,182	15,367	16,277	+5.9%	+7.2%
S&P 500	2,423	2,641	2,718	+2.9%	+9.0 %
Cdn 10 yr	1.75%	2.09%	2.17%	+8 bps	+42 bps
US 10 yr	2.31%	2.74%	2.85%	+11bps	+54bps

As is often the case in the world of investing, the worst performing assets often become the best performing assets, this underscores the basic principle of buying low and selling high! One of the best performing assets year-to-date, and over the past twelve months has been the energy sector, and businesses exposed to the oil industry. During the second quarter, the price of a barrel of oil increased by 14% and over the past year that same barrel was up 61%. We learned a long time ago to never make short-term or even medium term predictions on the prices of any commodities, so we will not be making any predictions now! The key is to buy great businesses, with business models that will not be derailed by fluctuating commodity prices!

Without making any predictions as to the exact value of gold and silver it is fair to say that precious metals are quite inexpensive (based on physical demand, supply and production costs) and well positioned to advance looking forward. Given the increasing level of inflation, the record levels of consumer, corporate and government debt, and the increasing trade concerns around the world, precious metals should be bid higher as the year progresses. We continue to own the world's leading royalty and streaming companies, in the precious metals space. If the markets do the "wild thing" on the downside, these companies should do the "wild thing" on the upside! Because they are all growth companies, they should continue to create long-term value, while protecting us from extreme volatility. The four royalty and streaming companies our clients have exposure to are Franco-Nevada, Royal Gold, Wheaton Precious Metals and Sandstorm Gold. Each one of these companies continue to generate record performance, despite weakness in the underlying precious metals. It is noteworthy to point out, that their respective stock performances have trounced the performance of the average gold or silver mining company, and also the performance of the underlying precious metals!

The table above (page 3), continues to point to the reality of increasing interest rates. The key question is: what level of interest rates will start to weigh meaningfully on economic activity? Though this question is difficult to assess in real time, we are increasingly monitoring areas of the economy that have seen an increase in leverage. We are particularly mindful of the fact that leverage in the corporate sector is high by historic standards and the corporate debt service ratio is rising. This could be the primary channel by which higher interest rates eventually pose a risk to the US economy, and by extension, to the global economy.

During the second quarter, the price of bonds continued to drop, with yields on both the 10-year government bonds in Canada and the US increasing by 8 and 11 basis points respectively. Year over year yields continued to climb, putting significant downward pressure on the value of bonds. When it comes to ROCKLINC, our investors are largely sheltered from the volatility in bond values, since we continue to invest in quality bonds with very short durations! While we watch to see how aggressive central banks will be in lifting interest rates, we continue to invest in short-term quality bonds for three reasons. First, they help dampen volatility in client portfolios. Second, all the fixed income (bonds) positions we own are liquid and can be sold quickly in the event the world's stock markets sell off, and we need some cash to take advantage of cheap equity prices! Third, as bonds mature, we are able to roll them over in bonds offering higher yields. **The bottom line is that the level of debt around the world cannot withstand a major move in rates, without bringing on a serious recession/depression in the global economy.**

B. ROCKLINC Investment Update

In terms of our ROCKLINC portfolios, in aggregate, across all our accounts, they were up 2.9% during the second quarter of 2018 and up 5.3% during the last 12 months (period ending June 30, 2018). Our average annual compound rate of return over the past 3 and 5 years is clocking in at approximately 7% and 8% respectively. Returns are after all fees, and are based on an asset mix of approximately 65% invested in equities, with the remainder invested in short-term deposit accounts, bonds and preferred shares. This asset mix has varied over the past five years but in general we have averaged approximately 65% invested in equities. Currently we are running closer to 70% in equities, at the end of the second quarter. Please note that the performance we are discussing is our aggregate performance across all our accounts. Each client's portfolio is unique, and performance will vary, based on your risk tolerances, specific asset allocation and when you invested.

When we dig further into our numbers, we find that our basket of equities actually increased by 3.8% during the second quarter, and by approximately 7% during the past 12 months. Our equities have been compounding by approximately 12% per year over the past 5 years. It is interesting to point out that there has been a significant difference in performance between Canadian and US equities. Over the past five years, our Canadian equities have been compounding at 9% per year, while our US equities have been growing at 17% per year! This points to the greater investment opportunities outside Canada. We will continue to allocate capital into global businesses and glean the benefit of global growth and diversification in your portfolios. Given the conservative nature of your portfolios, we are pleased with our progress, but are working hard to grow your portfolios even faster in the years ahead.

For the time being, as long as the market is volatile, our focus is on first, selectively adding new companies as we come across new opportunities, second, pruning underperforming businesses and third, taking full advantage of market swings that provide us with the opportunity to buy one of our exceptional companies at a great price! Warren Buffett calls this swinging at “fat pitches”. In the investing world you cannot strike out by not swinging, so wait for the best pitch rather than reaching for the tough ones!

The first half of 2018 has been exciting and we believe that we are progressing nicely. We have been able to hold our own and add a little value in the face of a volatile and sideways market. We expect the challenges to remain for the foreseeable future and will continue to be vigilant in protecting your capital. One way we protect and grow your capital is to find new opportunities for investment. One such opportunity is Roper Technologies. We have been slowly building a material position in this business.

C. Company Update - ROPER

Roper Technologies, Inc. is a diversified technology company. They operate businesses that design and develop software (both license and software-as-a-service) and engineered products and solutions for a variety of niche end markets.

They manage their business for consistent and sustainable growth in earnings and cash flow by emphasizing continuous improvement in the operating performance for their existing businesses and by acquiring new and complementary businesses that offer high value-added software, services, engineered products and solutions they believe are capable of achieving growth and maintaining their high margins. They compete in many niche markets and are either number one or two in virtually all of these markets. They also have a global presence, with sales to customers outside their home market of the U.S. totaling $1.3 billion in 2017 (29% of total revenue) and growing quickly.

In terms of the business model it is an “asset light” business which requires minimal capital expenditures and is highly scalable. As they grow their various businesses, their profitability increases, along with their free cash flow generation and returns on capital. In fact, their free cash flow is consistently over 20% of their revenue. Another wonderful feature of their business model is that over half of their revenue is reoccurring, and this number continues to increase as they build more consumable products and subscription based revenue streams. Customers are not only loyal but face substantial switching costs, which makes their revenue streams very sticky and highly valued.

In today’s world, businesses simply cannot operate without the highly developed and sophisticated software offered by firms such as Roper. Below we list their four main business segments.

Four Business Segments

Roper’s operations are reported in four segments. The segments are: RF Technology, Medical & Scientific Imaging, Industrial Technology and Energy Systems & Controls. Let’s take a brief look at each segment.

RF Technology

The company's RF Technology segment provides radio frequency identification ("RFID") communication technology and software solutions. This segment had net revenues of $1.86 billion for the year ended December 31, 2017, representing 40.4% of their total net revenues.

Medical and Scientific Imaging

Roper's Medical & Scientific Imaging segment offers products and software in medical applications, and high performance digital imaging products. For 2017, this segment had net revenues of $1.41 billion, representing 30.6% of our total net revenues.

Industrial Technology

Roper's Industrial Technology segment produces primarily water meter and meter reading technology, fluid handling pumps, and materials analysis solutions. For 2017, this segment had net revenues of $784 million, representing 17.0% of our total net revenues.

Energy Systems & Controls

Roper's Energy Systems & Controls segment principally produces control systems, testing equipment, valves and sensors. For 2017, this segment had net revenues of $551 million, representing 12.0% of our total net revenues.

In summary, Roper Technologies is the type of business we want to own for the long-term. It provides essential services and products within a scalable and highly profitable business model, and it is run by exceptional professionals. Over the past 15 years the company has grown its operating cash flow from $71 million to over $1.2 billion. In 2003 their cash flow returns on investment were approximately 30% per year and by 2017 that number had grown to an astounding 300%. During that same time, their stock has compounded by 19% per year versus the S&P 500 at 9% per year. We believe the future will continue to provide exceptional rates of return for Roper shareholders.

D. Moving Forward - Investing in Turbulent Times

As most investors know, the market is manic-depressive! Given the current state of politics and the manner in which information flows, or doesn't flow, through the main stream media, we can expect a growing level of "fake news" mixed in with some truth! We must be very discerning and remain focused on the "real fundamentals" and not ideological rants that seem to be coming from every direction. Our goal is to keep our eyes fixed on the fundamentals, and on the businesses we are investing in, on your behalf. We will do our best to take advantage of the moves in the market, which might be larger than what we have been accustomed to in the past! As investors, volatility and turbulence are friends and we must remain opportunistic.

Our basic strategy, continues to be summarized in the following six points!

1. Diversify across asset classes, sectors and geographic regions. At the current time we are focusing on eight sectors. These are, infrastructure, financial, technology, manufacturing, precious metals, healthcare, agriculture and water.

2. Invest in businesses with strong balance sheets, backed by hard and tangible assets.

3. Invest in firms that produce essential products and services, in growing industries, with long-term secular growth trends well established. Roper Technologies, which we have highlighted in this newsletter, is an excellent example.

4. Avoid/minimize highly leveraged financialized firms that have incomprehensible balance sheets, loaded with risky derivatives.

5. Maintain liquidity in our portfolios, in order to take advantage of significant moves in the stock market.

6. Stay optimistic and opportunistic without being naive to the risks all around us. **Investing in turbulent times can be rewarding, with the right investment philosophy and prudent execution.**

If you have any questions pertaining to your account please call or email for an appointment.

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