

Front Line Thinking

INDEPENDENT AND OBJECTIVE OBSERVATIONS FROM FRONTWATER CAPITAL | OCTOBER 2, 2015



“It tastes awful,
and it works.”

Remember the tagline for Buckley’s cough medicine? It tastes awful and it works. This latest quarter left a bitter aftertaste in the mouths of investors as the market sold off more than 10 per cent -- even after the Feds applied the right amount of medicine in holding interest rates steady. Nonetheless, we like the current state and we believe the market is working. Unlike last quarter when bargains were hard to find, there are now many attractive companies to be found for the long term investor.

WRITTEN AND PRODUCED BY



FRONTWATER
CAPITAL

In August and early September, the market sold off on fear that the US Feds would raise interest rates for the first time in 74 months. When the Feds actually held off hiking rates on September 17th, the market continued to move down. It goes to show that the market can be a machine unto itself. Rumours initially drove the market down. And even though the rumours proved untrue, the market still swooned on good news.

The US economy is most definitely in recovery mode as it regains its reputation as the world’s growth engine. However, it is a fragile one at best. Every positive leading indicator can be matched against a corresponding negative factor:

■ In Q2, the US economy recorded strong GDP growth of 4.2% and S&P earnings growth of 7.7%. In Q1, the US economy contracted

by 2.1% due to a combination of harsh winter weather, the strong US dollar, and labour unrest.

■ In Q2, US unemployment returned to its pre-Great Recession levels of 5.1%. Yet there was absolutely no wage inflation indicating salaries remain stagnant.

■ In Q2, Consumer spending, which accounts for more than two-thirds of U.S. economic activity, grew at 2.9%. Yet commodity prices, including oil, copper, nickel and zinc all continue to tumble with no bottom in sight.

With the DJIA and SPY both off their highs, expectations are very low right now and there is a tremendous amount of scepticism. But, let’s remember that there have been at least four so called doomsday scenarios over the last five years:

- The 2010 US S&P ratings downgrade
- The 2011 Cyprus situation
- The 2013 Fiscal Cliff, and
- Greece in 2014

Each flare-up turned out to be a buy opportunity. Should we be surprised that another volatile situation presents

itself today? Probably not.

Today’s market gyrations may feel a lot like old Buckley’s cough syrup but corrections like this latest one tend to keep the market strong. In fact, sell-offs are often exactly what the doctor ordered. The result is a healthier market with the kind of reasonable valuations that motivate investors to stay put and to ignore many of the day-to-day headaches. Of course, we still want the dance between the Fed and the stock exchanges to near its end. That would be the sweetest medicine of all.



WHAT TO EXPECT FROM THE FEDS

The US Fed did the right thing by not raising interest rates. Moreover, we expect Janet Yellen to follow in the footsteps of her predecessor, Ben Bernanke, in every way. She will not raise rates until the US and the world’s economy is on firmer footing. We also expect her to maintain her evasiveness as to the exact timing of any interest rate hikes. Keeping investors in the dark helps to prevent a market bubble from forming.

McGraw Hill Financial operates four lines of business that specialize in financial and data analytics. The businesses are all high quality ones with dominant positions in their respective markets and with tremendous cost structure flexibility.

Business #1: S&P Ratings

The ratings business may be the most beautiful operating business out there. It takes a special industry to not only survive scandal after scandal but also to maintain its oligopolistic stature.

Capital markets rely on rating agencies to rate and assess the riskiness of various investment entities. Historically this job was done by banks but over time even the banks gradually outsourced this function to third party credit specialists. Today, there are three firms that control 95 per cent of the market. S&P Ratings owns 40%, Moody's 40% and Fitch 15%.

After the financial crisis in 2008, these agencies were universally criticized for not only failing to warn investors but for assigning the highest credit ratings to the riskiest subprime mortgages. For a year or two, the agencies suffered some reputation risk

but today the agencies are more profitable than ever.

S&P Ratings generates revenues by charging just a small fraction of any new issue (ie. 0.005%). It is a relatively insignificant amount for any one company to pay but it adds up when applied across several thousand. Corporations are for all intents and purposes "forced" to pay in order to have their debt or equity issuances rated.

Not only is the service inelastic, but companies require a rating assessment from at least two of the three big agencies. This gives the ratings companies, including S&P Ratings, tremendous pricing power even if they do not take full advantage of it.

Business #2: S & P Capital IQ

S&P Capital IQ provides financial research and data. It services the financial industry including asset managers, investment bankers, advisers etc. For example, an asset



**MCGRAW HILL FINANCIAL (MHFI) \$86.50 USD
AS OF SEPTEMBER 30, 2015**

manager may want to analyze the historical price earnings ratio on an individual company or industry. Capital IQ stores all this historical information on its servers and makes the data accessible in a user friendly way. In exchange for this service, Capital IQ charges an annual subscription fee.

Much like the ratings business, Capital IQ is light on capital requirements with only a few competitors. The two biggest competitors are Bloomberg and Thompson Reuters. Together they are all able to coexist in a healthy and profitable manner.

Business #3: S & P Indices

S&P Indices provides global index benchmarks to the financial community. These benchmarks include the most important of all US indices including the:

- S&P 500 index (ticker symbol: SPY)
- Dow Jones Industrial Average Index (ticker symbol: DIA)

This is once again an absolutely wonderful business. It is also the perfect play to ride the shift from active to passive wealth management. As long as investors are buying passive S&P exchange traded funds (ETFs), those funds need to pay "management fees" to S&P Indices. While the fees are substantially lower than open ended mutual funds, it is a highly profitable business with stable and recurring revenue due to the large volume of capital invested in ETFs.

McGraw Hill Financials: MHFI has a market capitalization of \$28 billion. It also has a clean balance sheet, with enough cash (\$1.7B) on its books to offset its debt requirements (\$1.5B). Growth has historically been in the high single digits which is not sexy by any means. But the company is enticing when you consider that operating margins are in the neighbourhood of 30%+. The best part is that the four lines of businesses are not capital intensive so the company spews out a good amount of free cash flow each quarter.

	% of Total Revenue	Operating Margins	Annual Growth Rates
S&P Ratings	56% of total	40% operating margin	10% per year
S&P Capital IQ	18% of total	18% operating margin	mid single digits
S&P Indices	10% of total	60% operating margin	mid single digits
Commodities & Commercial	16% of total	30% operating margin	mid single digits

Business #4: Commodities & Commercial

Finally, the Commodities and Commercial provides research and data analytics for business to business. It is divided

CONTINUES ON PAGE 4

When best of breed companies are off their highs by 10-25%, it's time for the smart, value conscious investor to rub his (or her!) hands together with glee and go after some great deals.

It may sound ironic and counter-intuitive, but investors should feel great about this latest correction. Expectations in the market are simply very low right now and with the DJIA, S&P500, and TSX all 10% off their highs, there is good value to be had. The disciplined investor identifies market fluctuations caused by a case of the jitters and understands that when fear is out-performing greed, values are abundant.

CVS HEALTH

Baby Boomers are just starting to retire and with an ever-increasing arsenal of life-extending drugs coming to market, retail pharmacy chains like CVS Health, Walgreens and Rite Aid are sitting pretty. There are already about 80 million Americans over the age of 55. By 2019 this number will increase by 20 per cent or 17 million people.

But there's more. Each American on average spends more than \$1,000 a year on prescription drugs. Canada is second at over \$600. Now factor in the US government's growing commitment towards universal healthcare, and it is easy to see how this industry is projected to grow at 15 per cent a year. It is fair to say that the pipeline of drug store customers is well stocked for the foreseeable future.

For those who don't mind profiting off a stable and growing consumption of aging geriatrics, CVS Health is the best of the best. It operates

the largest pharmacy chain in the US with a market share of 54%. It also operates a high growth prescription business and has been one of the best-managed companies over the last 20 years with consistent double-digit growth rates.

Being the largest player means great benefits in negotiating power and greater brand value in the eyes of the customer. Moreover, CVS need not worry too much about new competition arising. The industry is consolidated and concentrated with high barriers to entry as not any one can start a retail

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CVS HEALTH (CVS) \$96.48 USD AS OF SEPTEMBER 30, 2015

pharmacy chain these days.

CVS also works with various corporations to help manage the prescription drug part of health insurance plans. Plan sponsors, such as self-insured employers, insurance companies, and health maintenance organizations, seek out CVS in order to provide high quality drug care at the lowest possible cost. In this capacity, CVS is known as a pharmacy benefits manager, or PBM.

The PBM business has high infrastructure and customer acquisition costs, both of which can impede the entry of new entrants. For CVS, the business offers a full array of services such as plan design and administration, formulary management, and mail order. But the most important one is acting as a middleman between the pharma companies and the buyers. Since the retail price of the drugs is the same for all PBMs (price is dictated by the pharmaceutical companies), having more bargaining power over the suppliers is the only way to lower costs – and CVS is the biggest player with the most clout.

Not only is CVS a leading edge company, but it is one of the few companies that makes

bold decisions, and “walks the talk” in order to stay true to its corporate mission of “promoting health and reducing the burden of disease.” In February 2014, CVS did just this by announcing that they were removing all tobacco products from its stores.

Going forward, the drugstore giant is adding walk-in clinics where nurse practitioners and other medical staffers will diagnose and treat minor injuries and illnesses. It will also continue to buy generic drugs at discounts, thanks to its partnership with Cardinal Health, Inc. Finally, just a couple months ago, the company spent \$1.9 billion to buy Target's in-store pharmacies – a brilliant move to add to their overall footprint.

But a great company or a great stock does not mean much if it's overpriced. In late July, CVS stock traded as high as \$113.45. Today, the stock is down more than 15% at \$96.91. It would be alarming if CVS was experiencing business losses due to operational issues – but it is alluring when there is no negative internal news. This is just one example of a well-managed company that is being dragged down with the riff raff – so look at each stock, not at the market.

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

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into two business segments, Platts and JD Power.

Companies rely on Platts to publish a fair and orderly benchmark price for those commodities where no public exchange exists. In fact, seventy per cent of global oil trades off Platt's pricing. And Platts is not constrained to just oil. It provides pricing for any number of commodities including petrochemicals, eggs, dairy, etc.

Meanwhile, JD Power is the premier information and data analytics provider for industries like auto and retail etc. They analyze customer satisfaction reviews and give opinions. Customers then pay for the right to use their name on a commercial or marketing advertisement. The brand, JD Power, is recognized as one of the top brands and plays a crucial role in its earnings power.

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	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

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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