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Fully invested again

Jonathan Ratner, Financial Post



Peter J. Thompson, National Post

After reducing their equity exposure by about 10% in the fall, Thornmark Asset Management's Daniel Bain and Andrew Pink moved back into a fully invested position after companies began reporting quarterly results. The portfolio managers

still see a number of risks out there, but are using leverage to position the portfolio at slightly more than 100% invested. About 35% of that is currently invested in U.S. equities.

"Fundamentally, we still do expect equity markets to outperform both fixed income and cash markets through the end of 2010," said Mr. Bain. "That's because on a broadening basis, economic data is improving."

Jobless look reminiscent of prior economic inflection points, he said.

The managers said they feel the level of economic growth will likely be somewhat muted relative to the recent past, yet consistent with longer-term norms. This depends on continued leadership from Asia, Mr. Bain said, which will be followed through in North America, then Europe.

"The deleveraging process that we still need to go through is one of the things that will contain overall economic growth," he said. "But if we see coordinated growth again on a global basis, then you would expect markets in general -- and commodity prices -- to move higher."

The fund hasn't made the shift out of large caps into smaller, higher opportunity names yet. The managers cited recent U.S. ISM data that confirms that risks are still present and that there is still cause for caution. These include high unemployment, low interest rates (free money) increasing risk of asset bubbles, and the transition of private to public debt resulting in massive national fiscal imbalances.

The managers also pointed to tight credit for small businesses (despite low interest rates), a strong Canadian dollar (bad for Canadian exports), unstable currency markets in general, and high oil prices, which are all normal types of challenges consistent with past economic inflections.

One issue of clarity is the upward direction of analyst earning revisions. Based on a 16.5x multiple of Thornmark's 2010 EPS estimates, local dollar equity market total returns through the end of next year remain in excess of 15% for both the S&P/TSX composite and the S&P 500.

It typically takes a year from the market low before the fund makes that shift into more aggressive investments, smaller cap stocks, and a more concentrated portfolio that incorporates additional growth, Mr. Bain said.

"Over the next couple of months, if the economic data continues to support our position, you should expect to see us starting that progression."

This will be reflected in a focus on more expansionary sectors like technology, industrials, and to some degree, consumer discretionary. The fund has reduced its exposure to utilities and health care, while

increasing its weighting in energy, financials and technology.

"We're still in recession territory according to the markets," said Mr. Bain, noting that the economic data continues to point to a V-shaped recovery. "But we think the markets can progress higher."

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BUYS

CGI GROUP INC. (GIB. A/TSX).

The managers initiated this position in the spring and added to it in early November. The stock's 15x multiple correlates with their long-term earnings growth estimates.

Government, financial (aided by TARP) and other enterprise spending on IT that had been put on hold while capital spending stagnated in the past year-and-a-half should begin to pick up, said Mr. Pink. He also pointed to CGI's healthy \$10.9-billion backlog at the end of the fourth quarter and the fact that roughly 60% of its revenues are recurring.

CGI also boasts a 10% free cash flow yield, strong projected EPS growth at roughly 6% and healthy operating margins at 12%. "This company represents a relatively safe name in the IT business. They have predictable recurring revenues from healthy client-base and an industry-leading backlog. They are successfully integrating themselves into the U.S. marketplace and winning key contracts."

POTASH CORP. (POT/NYSE).

The fund bul ked up on this name about a month ago and capitalized on its rapid appreciation. The

managers still see upside of about 10%.

Fertilizer producers faced a spending drought by retailers and farmers in 2009, said Mr. Pink, adding that commodity prices remain somewhat at risk. However, with its dominant market share, he thinks Potash Corp. may influence international pricing. In the meantime, it will participate in nitrogen, phosphate and potash sales at lower margins.

Negotiations with China -- the last major market holding out on a deal -- have been slow to materialize. However, the managers are confident that this will be settled by the end of the year, Mr. Pink said.

"To a certain extent, I'm less concerned about where they settle the price, but more that they establish a price in order to renew sales volumes in a market that has historically contributed to about a fifth of Potash's revenues."

HEWLETT-PACKARD CO. (HPQ/NYSE).

The managers recently added this name and see upside of roughly 30% for the stock. They point out that earnings expectations for 2010 are driven by domestic enterprise restocking trends and growth from international sales (more than 60% of revenue), fueled by improving economics and a weaker U. S. dollar.

The managers also note that HP is trading at a forward multiple of about 11x consensus estimates, low compared to historical levels -- making multiple expansion "the torque in this story."

Channel checks have indicated that about half of enterprise technology is older than three years, Mr. Pink noted.

The manager noted that while HP clearly paid up by spending US\$2.7-billion for 3Com, the deal will make it the number two company in networking, offers new marketing and branding opportunities, cost savings, and revenues from the rapidly growing Chinese market.

SELL

U.S. DOLLAR.

The managers are bearish on the U.S. dollar, expecting it will slowly drift lower, but not indefinitely.

As a result, they hedge out all U.S. dollar exposure through simple futures contracts.

Mr. Bain pointed to the massive deficit that must be funded, which represents a serious deterioration of the country's fiscal picture.

He also noted the unwinding of the safety trade that persisted for about a year.

"When you see a re-energizing of global economic conditions, that means there is less dependence on the U.S. dollar and investment flows will go elsewhere."

The manager feels factors like unemployment, the housing market and capitalization utilization all argue for a lower U.S. dollar, which will ultimately help the United States out of their economic challenges as foreign demand for American-made products rises.

THE MANAGERS

Managers: Daniel Bain & Andrew Pink, Thornmark Asset Management

Fund: Thornmark Enhanced Equity Fund

Description: Tactical allocation fund, use cash and equity, up to 25% leverage

Size: \$40-million

Style & Process: Value-Shift™ active-style allocation with a value bias

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