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Bullish pair see sustained recovery

Jonathan Ratner, Financial Post



Tim Fraser For National Post

After making their first equity allocation increase in March 2009, Daniel Bain and Andrew Pink gradually increased their exposure to stocks throughout the second quarter of last year. Since then, the portfolio managers have maintained

virtually full equity exposure in the Thornmark Enhanced Equity Fund.

"On balance, the data that we're looking at suggests the recovery is sustainable, it is gaining momentum, and is being led by the emerging economies," Bain says.

While developed countries have been a drag, the firm's chief investment officer notes that overall global industrial production is increasing, with the last reading only 3% below the prior peak.

"That's pretty impressive because until very recently, strategists, analysts and the media haven't really acknowledged the fundamental strength," Bain says. "Industrial production in developed economies are close to where we were in 2007 and emerging economies are well above their prior peak."

Despite Europe's debt issues, he points out that the region only accounts for about 3% of Canadian

exports. "It does have a real impact on the North American outlook, but I think it is sufficiently contained so it won't derail the global economic expansion."

While the managers have only begun to incorporate more small-cap stocks into the portfolio, they expect that transition will be well underway within the next quarter or two.

In this "early expansion" phase of the cycle, they are focusing on information technology and consumer discretionary names. In both cases, Bain and Pink lean heavily on the U.S. market since these sectors are very limited in Canada.

During the next six months, Bain expects to move into the mid-expansion phase where industrials and materials stocks will get a closer look "as we begin to see signs of inflation."

While the fund has a roughly 42% geographic allocation to the U.S. market, virtually all of that is hedged back into Canadian dollars.

"Right now, because we have believed and continue to believe that the Canadian dollar will appreciate against the U.S. dollar -- irrespective of the direction of the U.S. dollar against other world currencies -- we have been hedging out that exposure on a tactical basis," Bain says.

Despite their positive outlook, the managers believe the deleveraging that took 20 years to put in place will probably take between five and 10 years to unwind.

"That necessarily means that global economic output will be weaker than it would be otherwise," Bain says. "We expect that the deleveraging process will be a drag on output."

Another significant risk is interest rates, although the managers do not believe they will move back up

significantly. While the Bank of Canada is expected to raise rates soon, Bain and Pink don't think the Fed will hike rates until sometime in 2011.

"The risk isn't that the Fed or the Bank of Canada will raise rates, it's that market rates will increase more than expected," Bain says. "If that happened, it would destabilize the U.S. housing market and put a further financial burden on the U.S. consumer, which represents about 60% of economic output and needs to be there for this recovery to be sustainable."

Since the managers haven't done much selling recently and are focusing on opportunities, they have four Buys and no Sells.

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THE MANAGERS

Managers: Daniel Bain & Andrew Pink, Thornmark Asset Management

Fund: Thornmark Enhanced Equity Fund

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

Size: \$44-million

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

Performance: 1-year +23.70% 3-year -3.0%+ 5-year +8.25% (to April 30, 2010)

MER: 1.81%

BUYS

CGI Group Inc. (GIB. A/TSX).

The managers have owned this core holding for about a year, but continued to add to it as recently as February.

CGI recently announced its intention to acquire Stanley Inc., something the market had been waiting for given its \$400-million in cash and \$1-billion credit line. "They've now put idle capital to use," Pink says. "CGI is paying up for the asset at about 19 times 2010 estimated EPS, but it gives them unique exposure into a high quality U.S. government vertical."

It also adds another \$2-billion to CGI's existing \$11.4-billion backlog, which is key to the company's recurring revenue and earnings power.

Pink notes that this strategic advancement into the U.S. market, particularly within the financial and health care segments that are being reformed and require a lot of IT work, will represent part of CGI's growth opportunity over the next 12 to 18 months.

Finning International Inc. (FTT/TSX).

The managers see a compelling valuation for Finning, which they consider to be the best-positioned heavy equipment distributor globally. As the world's largest Caterpillar dealer, the company derives

more than 50% of its revenue from Canada's oil sands and 33% from South America.

"Finning's sales and maintenance businesses are leveraged to what we feel is going to be a strengthening base metal and commodity demand cycle coming from emerging markets," Pink says. "As commodity prices move higher, there will be more activity in oil sands and mining. That's where Finning draws its revenue from."

It recently sold its U.K.-based truck rental business, which was acquired in 2001. "The company has removed the overhang and can now focus on core business opportunities."

Rogers Communications Inc. (RCI. B/TSX).

"Bottom line, this company has the best telecom platform in Canada with nearly 40% market share," Pink says. "They have the scale and minimal platform-related capital costs over the next two or three years, which supports earnings and aligns with investor interests."

With Rogers' industry-leading wireless platform, the managers see an opportunity in the Canadian market where penetration is just 65% versus 93% in the United States. In terms of the risk posed by new wireless competitors, they feel it is a little overstated.

"There will be minimal effect on Rogers' earnings momentum from new entrants," Pink says.

"Potential for pricing pressure remains a risk, but is mitigated by a better product mix, improving cost management, better service and established client base."

Rogers has been a long-term holding in the fund and the position was increased in November.

Research in Motion Ltd. (RIMM/NASDAQ).

Another long-term holding, the managers note that RIM's multiple of 17.5x 2011 earnings is consistent with their long-term expected growth rate of 18%.

"We don't think the competition from Apple and Google is going to derail them on a global basis," Pink says, noting that the BlackBerry 6.0 OS (operating system) will be available in the third quarter. Not only will the new interface be more intuitive and user-friendly, but the draw on bandwidth is expected to be just a third of comparable devices.

"Carriers want the highest inverse relationship between user experience and bandwidth," Pink says.

"That's what 6.0 is going to give the carriers."

RIM should also capitalize on the shift to smart phones globally, which currently represent just 16% of total handsets.