cardinal UPDATE

AUGUST 2018

DIVIDEND INCREASES

Alimentation Couche-Tard Inc.	11.1%
JM Smuckers Co.	9.0%
PNC Financial Services Group Inc.	26.7%
Simon Property Group Inc.	2.6%
Wells Fargo & Co.	10.3%

(During the period July 1 to July 31, 2018)

STICKING WITH THE TRIED AND TRUE REWARDS INVESTORS OVER THE LONG-RUN

After a correction early in 2018, Canadian and U.S. markets have recovered and moved higher. All is not equal across the indices though. Momentum or growth oriented stocks have been outperforming value stocks. So it is worthwhile to take a closer look at what has been doing well and how it fits with Cardinal's investment philosophy.

In the U.S., the top 20 performing stocks in the S&P 500 for the 12-months ending June 30th contributed 4.5 points out of the 14.4% total return. That's about a third of returns coming from 4% of the stocks in the index. Some of the top 20 stocks could pass some of our tests such as strong management and an enduring competitive advantage, but what about valuation? Here most of them would fail!

The top 20 stocks in the S&P 500 have a trailing price to earnings ratio of about 27x on average compared to 21x for the overall index and 17x on Cardinal's U.S. portfolio.

On a price to sales basis, the top 20 were priced at about 6x sales versus 2x for the S&P 500. Lofty expectations are baked into the top 20 stock prices so any hint of trouble causes these stocks to quickly reverse course and fall. Facebook is an example of how quickly the market can turn negative.

This is not unusual. Investment styles are cyclical and do better at different times. The value style has outperformed over the long run and did so through much of the 2000's post internet bubble. Value did not fare as well in the lead up to the tech bubble, but value investors were happy to have been holding a sound, reasonably priced portfolio when that bubble burst! Despite different styles taking turns in the lead historically, some are wondering if the value style is dead.

We strongly disagree! First, investors tend to emphasize what's been working well recently; hence why people were chasing Bitcoin last fall. Second, buying assets at attractive valuations with solid growth and income streams will reward you over the long run. Buying based on momentum because it's done well the last few months, assumes the stock won't disappoint and suddenly the momentum is like a tightly wound spring that rockets back the other way. The Value philosophy can be more staid, but being boring helps when the next bear market arrives. Reasonably valued stocks tend to hold their value better in market downturns, providing downside protection.

Royal Bank or J&J will fare better than luxury goods manufacturers when demand suddenly dries up. In technology, we like names that don't rely on growth in the number of Twitter users and Facebook accounts yet have an important place in the sector such as Intel. Market leader styles will change over time. Knowing which style and when they will lead is almost impossible to predict. Knowing that value outperforms in the long term is why Cardinal sticks with a value investing style of focusing on large cap, dividend paying, dividend growing companies.

COMPANY FOCUS:

INTEL

In the past few weeks, many major technology companies in the U.S have taken big hits (Facebook, Twitter, Netflix), as user trends failed to meet expectations. As a result, we've seen large losses across the sector that has caused, in several cases, the baby getting thrown out with the bath water. Cardinal's position in Intel may be one of those victims, with the shares trading off materially in the last month on short-term, minor concerns. The market has become hyper-sensitive to the data center growth metric while ignoring any other segment gains, which caused a sell-off following their quarterly earnings release. The fact is that the company's transition to be a "data-centric" business, which shifted the dominant exposure away from PCs, is bearing fruit with half of their profits derived from these sources. Not only has the company become more diversified, it has also made large improvements in reining in its costs, which allowed the top line to soar double digits while expenses have remained flat. The shares are trading at the lowest levels in its five year range, providing great value for investors that are patient and can see through the noise.

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