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cardinal QUARTERLY

MARKET OUTLOOK

BY EVAN MANCER, CFA

Volatility picked up significantly in the first quarter, helped along by the Trump administration's tariff threats against China, which raises the odds of a trade war. At the same time, Central banks have continued to move toward more interest rate increases as the economy continues to do well and inflation has trended around the 2% mark in most developed countries. These fears have been balanced by what most investors expect to be a strong earnings season as companies benefit from U.S. tax cuts and a strong economy. The recent market pullback combined with earnings growth has also made valuations look more reasonable. We continue to believe that 2018 will be a positive year for the markets.

After a strong start in January, all of the major indexes dropped sharply in February and ended the quarter slightly lower. The UK FTSE-100 and German DAX-30 were the worst performing markets, down -7.2% and -6.3% respectively. The S&P TSX in Canada and the Australian ASX-100 fell by -4.5% and -3.4%. The best performing markets were the U.S. S&P 500 and French CAC-30, down -0.8% and -2.5%.

Politics have been the main source of volatility and the Trump administration jumps from one controversy to another faster than any U.S. government we can recall. In just fifteen months, the President has had verbal sparring matches with heads of most of the powerful institutions in the U.S. as well as many other countries and dozens of Fortune 500 companies. It is safe to say that there will be many more threats, firings and unexpected controversies in the rest of 2018.

But in a demonstration of how difficult it is to make good investment decisions based on Trump tweets, the new fear of a trade war with China has actually relieved our worry of NAFTA being cancelled. China is a higher stakes target than NAFTA and the U.S. likely prefers to have the support of its allies rather than having to fight two trade wars at the same time.

Both the Bank of Canada and the Fed have increased rates once already this year and the Fed appears on track for two or three more hikes. We still think further increases are in store for 2018, though the Bank of Canada has been softening its

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language as trade issues threaten the economy. The U.S. would likely soften as well if threats of a trade war with China begin to materialize. Central banks have been very cautious about hurting the economy by tightening too soon. The new risk now though is that inflation has also been pushing above the 2% that most Central banks target, a situation that could eventually leave Central banks with no choice but to raise rates further.

Rising interest rates has been a bigger negative for dividend investors, particularly in Canada, as some of our best dividend paying companies, such as Fortis, Enbridge and Emera have all fallen in value. When interest rates rise, safe, dividend paying stocks look less attractive since many investors purchase them as bond proxies. In our opinion, the falling valuations make these stocks more attractive. The three stocks mentioned average just 15 times earnings, have a growing 5.5% average dividend yield, and also act as safe havens if the economy takes an unexpected turn for the worse.

In the U.S., the stock market continues to favor growth companies. Despite sharp share price drops for companies like Amazon, Facebook and Tesla in early March, these companies have performed in line with the index in the first quarter and have far outpaced it over the past year. Each of these companies still has a strong growth story, but with an average price to earnings ratio of well over 50 (Facebook is the cheapest at 25 or so), a retreat to a more normal valuation carries huge downside risk. Slower growing value stocks have underperformed growth for the past decade but this will change eventually. Thus, we are continuing to look for opportunities to purchase high quality value oriented companies.

The Canadian dollar fell slightly in the first quarter but has since rallied back to flat on the year at $0.79 as WTI crude oil prices have risen to over $65 per barrel. We think this price makes sense as continued support from OPEC and Russia on supply cuts combined with strong global demand should offset rising supply from U.S. shale. If the Iran nuclear deal falls apart, oil will likely move closer to $70 and push the Canadian dollar into the low $0.80s. ■

INVESTMENT Q&A

Why did we sell Microsoft/PNC?

Over the last year, we've seen a strong run in the U.S. market on positive economic data and tax stimulus. For some of Cardinal's holdings, this has meant the shares have met and exceeded our fair value targets. As a result, we saw the opportunity to realize gains and move into more reasonably priced alternatives. Microsoft and PNC are both examples of this. While there was nothing wrong with either of these companies fundamentally, both were trading above their justified valuation range.

Our Microsoft thesis played out as well as, if not better than, expected. Its cloud business gave the company the ability to grow revenues quicker than peers, and margins were beginning to expand faster than expected. Also helping was the fact that the PC market had stabilized, which provided a stable base of profitability and cash flows to continue to invest in high growth areas. All of these factors, in combination with tax reform, contributed to the run up in valuation.

PNC also has very compelling reasons to own the stock including being a disciplined acquirer. It has delivered on expense efficiency promises and has benefited from both rising rates and lower taxes. However, the valuation at the time of our sale reflected a full valuation of its stake in Blackrock, as well as significantly higher net interest margins and expense efficiencies. While we continue to like the bank and would not preclude buying it back at lower levels, the valuation relative to our other bank holdings has widened to a point where we see better opportunities for capital allocation elsewhere.

Following our discipline to sell overvalued stocks, we sold both positions and re-invested the capital to lower valuation names.

ANDREA HORNBY, CFA

Why do you see more value in Canada vs U.S.?

As measured by forward 12 month P/E ratios, the S&P 500 (U.S.) trades at 17.2x while the TSX Composite (Canada) trades at 15x. This compares to the 10 year average difference between the two indices of just 0.1x. On this measure, it would appear that Canada is "cheaper". However, we can easily poke holes in this analysis. The Canadian index has higher weightings in Energy and Materials, which one could argue "deserve" a lower multiple than U.S. technology and industrial companies. Further, this analysis doesn't really tell us anything because we don't invest in the index. We utilize a bottoms up approach via researching individual companies.

We see good value in Canada vs the U.S. because as we compare certain companies with their U.S. or international peers, Canadian companies with similar or superior growth prospects, leverage, and geographic exposures trade at lower valuations simply for being Canadian. Thomson Reuters, a business with less than 5% of its revenues in Canada and leading global market positions, trades at 15.3x P/E versus its peers at 17.7x. Magna International has just 16% of sales exposed to Canada and has compounded earnings at 15% per annum over 5 years, yet trades at 8.5x earnings versus 11.5x for its closest peers. Our two utilities, Fortis and Emera, both own large U.S. utilities and have grown earnings much faster than peers in the Dow Utility Index over the last five years (7.5% vs 1.8%), yet trade at 15.5x versus the index of 16.0x. We see no fundamental reason for these valuation discrepancies, which is driving our decision to invest greater capital into our Canadian holdings.

JEFF RANCE, CFA ■

CARDINAL RULE #3

BE PATIENT

BY CLINTON REBEC, FCSI, MBA, CIM

Let's begin with the old adage "patience is a virtue". Whether you exercise it or not – we all understand the importance of patience in life.

When looking at the stock market why is patience so closely linked to success? Successful money managers understand that wealth always accumulates over the long-term. Investors who have a solid, time-tested strategy put themselves in a position to be ahead of the crowd. Those who are fixated on short-term results or chasing performance or fads ultimately damage their long-term success. Short-term thinking is an initial symptom that if not addressed can spread to a disease called "Impatience".

As Warren Buffett explains "the stock market is a device for transferring money from the impatient to the patient". We live in a culture and a world of immediacy. There always seems to be a relatively high amount of chaos or turmoil, which is what the media will fixate on. That same media then correlates this to the stock market. Whether we are hitting new highs or the markets are in a slump, the headlines create anxiety.

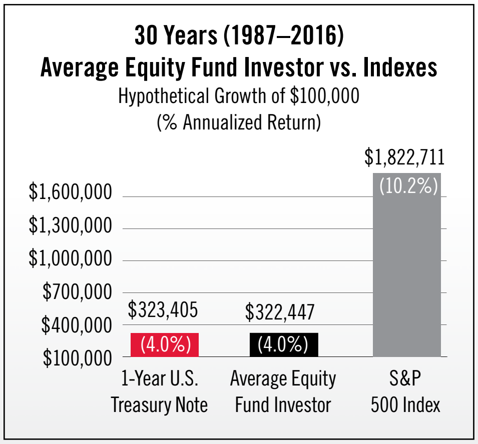
The markets have been and will always be volatile to a certain degree – that's normal. While it's easy to get wrapped into global economic issues, political uncertainty and the media's portrayal, it will serve as no benefit to your portfolio and the individual goals of you and your family. As economist Paul Samuelson stated "Investing should be like watching paint dry or watching grass grow. If you want excitement…go to Las Vegas."

Warren Buffett's mentor Benjamin Graham stated "the investor's chief problem and even their worst enemy is likely to be themselves." This is exemplified in the DALBAR annual (year-end 2016) Quantitative Analysis of Investor Behavior study that examines investor performance. Their goal is to provide information that improves performance by managing behaviors that cause investors to essentially hurt themselves.

	Investor Returns[1]					
	Equity Funds	Asset Allocation Funds	Fixed Income Funds	Inflation	S&P 500	Bloomberg Barclays Aggregate Bond Index[2]
30 Year	3.98	1.85	0.57	2.65	10.16	6.34
20 Year	4.79	2.29	0.48	2.13	7.68	5.29
10 Year	3.64	1.78	0.40	1.83	6.95	4.34
5 Year	9.83	4.85	0.05	1.40	14.66	2.23
3 Year	3.42	1.45	-0.23	1.25	8.87	3.03
12 Months	7.26	5.48	1.23	2.07	11.96	2.65

[1] **Returns are for the period ending December 30, 2016.** Average equity investor, average bond investor and average asset allocation investor performance results are calculated using data suppplied by the Investment Company Institute. Investor returns are represented by the change in total mutual fund assets after excluding sales, redemptions and exchanges. This method of calculation captures realized and unrealized capital gains, dividends, interest, trading costs, sales charges, fees, expenses and any other costs. After calculating investor returns in dollar terms, two percentages are calculated for the period examined: Total investor return rate and annualized investor return rate. Total return rate is determined by calculating the investor return dollars as a percentage of the net of the sales, redemptions and exchanges for each period.

[2] Amended May 1, 2017.



30 Years (1987–2016)
Average Equity Fund Investor vs. Indexes
Hypothetical Growth of $100,000
(% Annualized Return)

Source: DALBAR 2017 QAIB Study. Morningstar.

The message over the years remains unchanged – most investors drastically lag index returns and continue to suffer long-term for their short-term errors. For the trailing 30-year period to end 2016, the US stock market earned an annualized 10.16%, or over 2.5X the investor return of 3.64%. Meaningful gaps are apparent across all time periods.

Let's not lose sight of the mental capital and emotional exhaustion that goes into this underperformance. As shown below, lost years of compounded values will be significantly material to one's life.

At Cardinal, our clients and partners have benefited from a strict value investment philosophy and our core rules, which keep us disciplined! Our process has led to a strong history of out-performance vs. our peers and the market with lower-than-market volatility.

While patience will always be tested, having a diversified portfolio of high quality companies allows our portfolio management team to be patient. While there will be challenging times down the road, our clients and partners will be able to take solace knowing there is a steady pair of hands managing their wealth.

Q1 DIVIDEND INCREASES

Canada	% Increase
Canadian Natural Resources	21.8%
The Toronto-Dominion Bank	11.7%

CARDINAL RESEARCH

MEDTRONIC

BY DAVID AIME, CFA

We had the opportunity to meet with Medtronic (MDT) in early March and also tour some of their Research and Development facilities in Minneapolis. MDT is the world's largest medical device company with a diverse array of products covering areas such as cardiac and vascular, spine, brain therapies, and pain therapies. MDT has been a consistent long-term grower and its product portfolio has a solid balance between new high-growth areas and older low-growth segments which are highly profitable.

We have seen a shift away from open surgeries toward minimally invasive procedures as it is safer for patients and requires much less recovery time. MDT has both implantable products that replace the open surgery option as well as the surgical tools to complete the less invasive procedures. MDT is also developing a surgical robotic system that will further enhance their minimally invasive surgical offerings.

MDT has been one of the first medical device companies to push for value-based care contracts, whereby payment for their devices are contingent on the device's performance. In an era where there is a large focus on reining in healthcare costs, this is a model that is likely to see continued uptake and is a trend that should bode well for MDT given its scale and diverse product offering.

The diabetes segment is one of MDT's largest growth opportunities, with the recent launch of the MiniMed 670G insulin pump system. The 670G is the world's first hybrid closed loop system that constantly self-adjusts to keep glucose levels within a target range and is one step closer to the ultimate goal of an artificial pancreas. The device was approved much earlier than expected by the FDA and thus MDT did not have the necessary sensor manufacturing capacity to meet demand. With sensor manufacturing capacity now at adequate levels, MDT should be able to gain market share in the insulin pump space. MDT also recently received approval for Guardian Connect, a standalone continuous glucose monitoring (CGM) device which presents another growth opportunity in the diabetes segment.

MDT's diverse product portfolio has allowed it to deliver long-term consistent revenue and earnings growth, and we expect this to continue into the future. MDT should be able to grow earnings per share at a high-single digit percentage rate, and dividend growth should be at least in-line with earnings growth. This will allow MDT to extend its dividend growth streak, which currently sits at 40 consecutive years. ■

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