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BRITAIN IS ON SALE!

By Gavin Graham, Contributing Editor

Amid all the doom and gloom in the aftermath of the Brexit vote, many investors are overlooking the fact that the country now offers some great deals for value investors.

Share prices on the London exchange are under pressure and there is concern that commercial and residential property values in the city may turn down if uncertainty puts a brake on foreign demand.

As I write, the Canadian dollar is trading at $1.68 to the pound, meaning it buys 15% more than before the referendum. That's great for those planning to visit Britain this summer, but it also means that U.K. assets cost Canadians 15% less.

I'll have some specific suggestions on investments that look attractive right now later in the article, but first some background.

How we got here

On June 23, Britain voted by a 52% to 48% margin to leave the European Union (EU), after 43 years of membership. Electoral turnout was 71.8%, the highest since the 1992 general election, and more than 30 million people voted. About 17.4 million chose to Leave, 1.3 million more than the Remain side.

It was the biggest popular vote in U.K. history. By comparison, the Conservatives received 11.3 million votes in last year's general election and the opposition Labour party got 9.3 million.

The repercussions in financial markets were immediate and severe, in part because investors had convinced themselves that Remain was the likely outcome. On that faulty assumption, the pound sterling hit a 12-month high of US$1.50=£1 on the day of the vote, while the FTSE100 Index rose 7% during the week up to close of business that day.

With opinion polls showing a small lead for Remain, and the betting markets reflecting less than a one in four chance of a Leave vote, most investors were dumbfounded as early results showed large leads for Leave in traditional Labour-supporting areas such as the North East of England, Wales, and the Midlands. Those margins were enough to overcome the Remain majorities in London, Scotland, and Northern Ireland.

England itself voted 53.4% to Leave, despite London voting 60% to

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Remain. Wales also voted for Leave by 52.5%. Scotland and Northern Ireland voted Remain by 62% and 55.8% respectively.

Political fallout

The political fallout was immediate. Conservative Prime Minister David Cameron, as I noted in my last article on Brexit in April, had only called the referendum due to pressure from the Eurosceptic U.K. Independence Party. That was a fatal mistake. Mr. Cameron failed to gain meaningful concessions from the European Union and then ran a lacklustre campaign for Remain that was dubbed Project Fear by opponents due to the warnings that Britain would suffer a recession and house prices could fall if Leave won. After the result went against him, he was unable to carry on and he resigned.

He has since announced that he will not invoke Article 50 of the Treaty of Lisbon, which sets the exit negotiations in motion. That will be up to the next Prime Minister, who will be the person to negotiate the withdrawal.

There have been prophecies of doom from the Remain camp, some of which is sour grapes about losing the vote. There are elements of an attitude of “You broke it so now you own it” as they watch the struggle to become the next leader of the Conservative Party and hence Prime Minister.

There was certainly much glee when the charismatic ex-Mayor of London, Boris Johnson, whose move to the Leave camp probably swayed a number of votes, was ruthlessly knifed by his co-campaigner, Justice Minister Michael Gove, a few days after winning the vote. Mr. Gove was one of five candidates for the leadership but was soundly beaten in the first round. The favourite is Home Secretary Theresa May, even though she supported Remain. However, favourites rarely emerge as winners in Conservative leadership votes. Junior Finance and Energy Minister Andrea Leadsom, who will face off with Ms. May on the final ballot, performed well for the Leave campaign and may receive votes from Johnson supporters; he has endorsed her campaign.

Ironically, the party worst affected by the referendum result has been Labour, whose hard left leader Jeremy Corbyn fought a half-hearted campaign for Remain. Dissatisfaction with him amongst his MPs boiled over in the week after the vote, with 65 shadow ministers resigning and 172 of his 233 MPs demanding he step down. At present, Mr. Corbyn is clinging to office, supported by the 300,000 new members who voted for him after having joined the Labour party last year for £3 (one of his predecessor’s Ed Miliband’s more stupid ideas). If Labour is unable to function effectively, the Scottish Nationalist Party (SNP), with 56 MPs at Westminster, could take over as official opposition. Its leader Nicola Sturgeon is demanding a second referendum on independence.

Meanwhile, Nigel Farage has resigned as leader of UKIP, having achieved his lifelong ambition to extract the U.K. from the EU. UKIP, which received four million votes (13%) in the 2015 election, could easily take over from Labour as the party representing working class interests in its traditional strongholds of the Northeast and Midlands, as the SNP did in Scotland, where Labour went from 42 MPs to one last year.

In the midst of this political turmoil, whoever becomes PM has to negotiate Britain’s exit. This will only begin when the U.K. government triggers Article 50, after which there are two years to negotiate a settlement. The end result may be similar to those arrangements that Norway and Switzerland have with the EU as part of European Economic Area (EEA). This allows them to be part of the single market and adhere to EU rules. However, it implies free movement of labour, which was one of the major issues that gave the Leave camp its victory. All of the Conservative leadership candidates have made it clear that the U.K. must regain control of its borders, and this is where the negotiations will become interesting.

Financial fallout

Sterling plunged during the night of the vote by over 10%, touching a 31-year low at US$1.315=£1 the following morning. The FTSE100 opened down 8%. European markets were even more affected as German, French, and Italian stocks sold off by more than 10%, even as the euro strengthened by over 6%.

Essentially, the markets and conventional wisdom were wrong, and were caught with long positions in sterling assets, which they then needed to dump quickly. The markets functioned well, there were only minor pauses when volumes overwhelmed trading platforms, and U.K. retail investors were quick to take the other side of the trades, with many brokers reporting record volumes of small buying orders from their retail clients.

Mark Carney, the Canadian Governor of the Bank of England, announced that the Bank stood ready with £250 billion in liquidity to support any financial institutions that had issues. With the banks themselves in much stronger shape than in the 2008-09 crisis, markets began to recover as calmer heads prevailed. Sectors perceived to be vulnerable to the effects of Brexit, such as house builders, airlines, and banks, ended down 20% or more

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the day after the vote, having briefly fallen 40% in some cases. But exporters such as pharmaceuticals Glaxo and AstraZeneca, manufacturers like Rolls Royce, and consumer staples companies like BAT (tobacco) and Diageo (alcohol) were actually up on the day.

Meanwhile investors dived for the supposed safe haven of government bonds. Yields on 10-year British gilts fell to an all-time low of under 1%, and German and Swiss 10-year bond yields became even more deeply negative at -0.15% and -0.55%. Gold, long thought of as the ultimate refuge in times of tumult jumped to over US$1,300 an ounce, bringing its increase for the year to 25%.

Since then, the FTSE100 has recovered all of its post-Brexit losses. In fact, it is actually up for the year. Given that 75% of the revenues of the companies in the index come from exports or are generated in non-sterling countries, this is unsurprising. But even the more domestically oriented FTSE250 Index, which comprises the next largest 250 companies in the index, has recovered half of the 13% fall it experienced after the vote.

Of course sectors within the indexes have behaved very differently. The banks, insurers, and house builders are still down substantially, while defensive sectors such as pharmaceuticals, tobacco, food, and exporters generally are holding up well and are even up more than 10% in some cases.

Gold

Gold staged a strong rally once the Brexit result was clear. U.K. listed miners Fresnillo and Randgold are up 28% and 14% in the last week and 162% and 116% year-to-date. Of course these prices are in sterling, which has weakened against the Canadian dollar.

Gold is now out of its four-year bear market, as I noted the last time I wrote about my three Canadian-based recommendations: Agnico Eagle (TSX; NYSE: AEM), Franco-Nevada (TSX; NYSE: FNV), and Goldcorp (TSX: G; NYSE: GG). Despite their strong moves, all three are still Buys. The Brexit vote was motivated at least in part by the failure of globalization and free trade to deliver benefits to a lot of the electorate. If it is mirrored in the U.S. this fall, we could have Donald J. Trump as the next president! If that were to happen, there is no telling how high the price of gold could go.

For currency traders, I recommended in my pre-Brexit column that they reduce their sterling exposure and wait and see how the referendum panned out. They had already made substantial gains on the currency over the last two years as the loonie weakened on lower commodity prices.

Stocks

Effectively, the U.K. is now on sale, with prices marked down by 15%, and on some stocks by over 30% in Canadian dollar terms. As Warren Buffett said, an investor should be happier when your stock goes down in price than up, as it means the excellent business you liked is now cheaper. Of course, this requires the ability to be unemotional about your investments, which is often difficult when there is a lot of volatility such as accompanied the Brexit vote.

Brave investors could start to open positions in selected U.K. stocks. I have food group Unilever (NYSE: UL) and drinks group Diageo (NYSE: DEO) as Buys and they're now cheaper in Canadian dollar terms.

Investors who are interested in the U.K. market should look at specific sectors. I like airlines such as IAG (OTC: ICAGY), which owns BA and Iberia, and discount carrier Easyjet (OTC: ESYJY). More tourists will visit the U.K. now it's cheaper.

Life insurers such as Aviva (NYSE: AV) and Legal and General (OTC: LGGNY), and house builders such as Persimmon (OTC: PSMMY) and Berkeley (OTC: BKGFY) are worth considering, as they are down more than 30%. The Bank of England is relaxing capital rules to ensure stability and house building is an easy way to counteract any downturn, especially as the U.K. has been underbuilding homes by 100,000 per year, only producing 150,000 vs. the 250,000 required to house Britain's growing population.

So Brexit is not all doom and gloom for investors. As with any crisis, it has also created opportunities.

Contributing editor Gavin Graham is with us this week with the view from the U.K. about Brexit and what happens next. Gavin has had a long and successful career in money management and is a specialist in international securities. He held senior positions in financial organizations in London, Hong Kong, and Toronto. He currently is chief strategy officer at Integris Pension Management, a provider of personal pension plans for incorporated individuals. He divides his time between Toronto and the U.K.

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FIRST HALF FINISHES ON A HIGH NOTE

By Gordon Pape, Editor and Publisher

After two days of double-digit losses following the Brexit vote, the TSX rallied back to end the first half of 2016 with a gain of 8.1%. Considering the weakness of our economy and the messy state of world stock markets, that was quite an achievement.

Among major world markets, only Brazil did better. Like Canada, it was rebounding from big losses in the energy and mining sectors so the gains were only a partial recapture of lost ground. As Forbes contributor Kenneth Rapoza wrote about Brazil's market recovery: "It's been beaten up for so long that it had no place to go but up". He might have said the same about Canada.

But these days, investors will take profits wherever they can find them so Canada's performance has been welcome news. We beat New York by a wide margin – the S&P 500 was ahead only 2.7% in the six months while the Dow gained 2.9%.

Most of the rest of the world was in shambles. France and Germany were off around 10%, Japan lost over 18%, and Hong Kong was down 5%. Surprisingly, London's FTSE100 finished the first half ahead by 4.2%, despite the sell-off after the Brexit result was announced.

The big run-up in gold that we've seen in recent months boosted the S&P/TSX Global Gold Index by 95% in the first half, an astonishing turn-around. Other miners also benefited, with the Capped Metals and Mining Index ahead by almost 67% over the six months.

With rates sliding ever lower, interest-sensitive stocks were also among the TSX leaders, although the gains were nowhere near as dramatic as those posted by the gold miners. The S&P/TSX Capped REIT index was ahead by 17.8% for the period, recovering all its 2015 losses and then some. Telecoms were ahead by 14.9% while utilities added 14.7%.

The energy sector benefitted from the recovery in the price of oil, adding 17%, although the stocks are still trading well below their highs of 2014, before the price wars began.

Given the unpredictability of the first half, forecasting the next six months is difficult. Had the British voted to remain in Europe, the scenario for the rest of the year would have been more predictable: continued slow economic growth, a modest upward move in interest rates, and a small recovery in oil prices. Now it appears the second half of the year will be dominated by Brexit talks and the Donald Trump presidential candidacy. Neither will give comfort to the markets.

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TSX LEADERS: BOYD GROUP

By Gordon Pape

We continue our series on IWB recommended companies that are beating the TSX Composite this year with a look at Boyd Group Income Fund. Here are the details.

Background: Boyd is in the auto repair business, with operations both in Canada and the U.S. It is the largest operator of non-franchised collision repair centres in North America in terms of number of locations and it is one of the largest in terms of sales. The company operates locations in five Canadian provinces under the trade name Boyd Autobody & Glass, as well as in 19 U.S. states.

This is one of the few income trusts that did not convert to corporate status when the tax laws changed. Boyd's management said at the time they saw no advantage to making the switch and has stuck by that decision.

Stock performance: Boyd has performed outstandingly well for us ever since the stock was recommended by contributing editor Ryan Irvine at $5.50 in August 2010. One year later the shares had doubled in value and they have climbed steadily higher ever since. They closed on Friday at $74.22, up 1,249% since the original recommendation and 12.3% from the $66.10 where they ended 2015.

Why we like it: The company has two growth tracks, both of which it is exploiting effectively. Organic growth through

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Boyd – continued from page 4…

an increase in same store sales increased 5.6% in fiscal 2015 plus the company is actively acquiring new locations providing the price is reasonable. The shares pay a monthly distribution of $0.042 per unit ($0.504 per year).

Recent developments: The company reported first-quarter results in May. Same store sales were ahead by an excellent 7.4% and the company added 20 new locations over the period, so the growth story remains intact.

Sales increased year-over-year by 24.3% to $350.4 million. Adjusted net earnings were ahead 60.4% to $12.8 million, up from $8 million in 2015. Adjusted net earnings per share came in at $0.714, up 46% from $0.489 last year.

Outlook: The company has set a target of doubling its business by 2020 and management says it is on track to achieve that. "The positive industry trends that drive same-store sales growth, our strong balance sheet, along with 'dry power' of $350 million, position us extremely well for continued growth and continued investment in our business," said CEO Brock Bulbuck.

Action now: Boyd Group is a Buy.

GAVIN GRAHAM'S UPDATES

Empire Company (TSX: EMP.A; OTC: EMLAF)

Originally recommended on Jan. 18/16 (#21603) at C$24.32, US$17.77. Closed Friday at C$20.05, US$15.25.

Background: This Nova Scotia-based firm is the parent company of the Sobey's and Safeway supermarket chains, and owns a 41.5% stake in Crombie REIT.

Recent developments: Last week Empire reported disappointing earnings for the year ended April 30. Empire took a $1.3 billion non-cash impairment charge on the Safeway chain in the fourth quarter to leave it with a loss of $942 million ($3.47 per share) compared to a profit of $55.4 million ($0.20 per share) the previous year.

Sales rose from $5.8 billion to $6.3 billion, but this included an extra week compared to 2014-15. That added $461.2 million in extra sales and $7.4 million to profit. Adjusted for these exceptional items, Empire's profit fell 30% to $95.3 million ($0.35 per share) from $136.7 million ($0.49 per share) and the stock responded by tumbling 15% to under $20. It is down 18% from where I recommended it in January.

Together with the $1.6 billion write-down in the third quarter, Empire has now written off half the $5.8 billion it spent to buy Safeway in 2013. When I recommended the stock, CEO Marc Poulin (who resigned on Friday) had admitted the company had underestimated the impact of all the changes it had made to Safeway, and the share price appeared to reflect that, having fallen 25%.

However, commenting on the results, Mr. Poulin pointed to a switch by consumers to bargain shopping, especially in Alberta and Saskatchewan, which were hard hit by the energy recession. Empire's low cost chain FreshCo only operates in Ontario, though Mr. Poulin said the "prospect of expanding FreshCo is top of mind…it's a concept we're quite pleased with." We'll see if his successor decides to go that route.

In the meantime, Empire is slashing prices and costs as it streamlines its supply chain and renovates key stores. However "the stabilization and eventual return to a successful level of growth in our business is clearly going to take time" he warned, without being more specific on timing. His sudden departure will probably lengthen the process.

Even worse, in the fourth quarter Empire "saw evidence of a softening sales trend in other regions of the country" and the supermarket industry as a whole is feeling the weakness, not just the oil-producing markets. "That said, we are …maybe more challenged than other players. So we will acknowledge our own weaknesses," he said.

One small reason for optimism is same store sales growth (SSSG), always the most important metric to use when looking at retailers. While SSSG was down 1.8% from last year, after adjusting for lower fuel prices and excluding Safeway, Empire actually experienced 0.2% SSSG growth. But this is a small consolation given the company's performance.

Empire remains a conservatively financed operation, with the ability to generate cash by conducting sales and leasebacks of its grocery stores with its 41.5% owned Crombie REIT. In May, Empire sold 19 stores and a half interest in three automated distribution centres to Crombie for $360 million and the REIT agreed to invest $58 million on renovations of 10 Sobey's stores on properties it already owned. In return, Empire invested

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Gavin Graham's updates – continued from page 5…

$93.4 million in new Crombie units to maintain its ownership. The remaining $324.6 million will be used for debt reduction, reducing Empire's interest costs.

Finally, Empire raised its dividend by 2.5% to $0.1025 per quarter, giving it a yield of 2.12%.

Action now: Despite its disappointing performance so far and the departure of its CEO, Empire remains a Buy for its defensive qualities, solid balance sheet, and ability to raise funds through its relationship with Crombie.

Home Capital (TSX: HCG; OTC: HMCBF)

Originally recommended on Aug. 18/13 (#21330) at C$31.75, US$31.76. Closed Friday at C$30.33, US$23.59.

Background: Home Capital, through its mortgage lender Home Trust Co., makes loans that the banks normally refuse. These are usually to borrowers with credit histories that do not meet the banks' criteria. They include the self-employed, recent immigrants, and those who work in sectors such as entertainment and media, which do not have as much perceived job security as other professions.

Stock performance: The share price more than halved from $50 in early 2015 to below $22 earlier this year. This was due to concerns over mortgages in oil-dependent provinces in the Prairies. The decline was compounded by revelations of falsification of income of the clients of 45 brokers, with $1.55 billion in mortgages outstanding at end 2015 (6% of assets). Home Capital has suspended dealings with these brokers and the price has now rebounded 35%. The recovery partially reflected the fact that the review of the outstanding mortgages is now three quarters complete with no issues identified. It also reflected the takeover of Schedule 1 Bank CFF Capital for $23.2 million in late 2015, which allows Home Capital wider interest margins. Another factor is the pending retirement of CEO Jerry Soloway after 30 years, with President Martin Reid, a six-year veteran, taking over.

Recent developments: In 2015, Home Capital earned adjusted net income of $288.8 million ($4.11 per share) against $289.1 million (also $4.11 per share) the year before. Assets totaled $20.5 billion versus $20.1 billion at the end of 2014. While return on equity (ROE) was lower (18.8% vs. 22%), Tier 1 capital was unchanged at 18.3%. Non-performing loans (NPLs) were lower at 0.28% vs. 0.30% and book value per share, the most useful measure of a financial company's progress, rose 12.1% to $23.17. The dividend was increased 9% to $0.22 per quarter.

In the first quarter, adjusted net income was lower at $67.5 million ($0.96 per share) vs. $72.2 million ($1.03 per share) last year, excluding a $3.7 million charge related to severance. ROE was lower at 16.6% and NPLs were 0.34%, against 0.28% in the fourth quarter. Net interest margin was 0.1% higher at 2.38%, book value was up 2.5% over the quarter to $23.75, and the company redeemed $150 million of debentures, which will reduce interest expense by $1.8 million per quarter. The company also repurchased 3.99 million shares at an average cost of $37.60 over the year, reducing its share count by 5.7%. The dividend was increased another 8.3% to $0.24 a quarter giving a yield of 3.13%.

Action now: Home Capital remains a Buy. It successfully came through the recent downturn in mortgage lending caused by the suspension of relationships with the 45 brokers, reduced its interest costs, and grew its credit card and non-mortgage business, which now produces 7.2% of net interest income on 3.9% of the assets.

GORDON PAPE'S STOCK UPDATES

WSP Global (TSX: WSP, OTC: WSPOF)

Originally recommended by Tom Slee as Genivar Inc. on July 9/12 (#21224) at C$22.40, US$22.18. Closed Friday at C$39.18, US$30.07.

Background: WSP is an international engineering and design firm that provides a wide range of services, from urban planning to environmental remediation. Based in Montreal, the company employs approximately 34,000 people, including engineers, technicians, scientists, architects, planners, surveyors, and environmental specialists, as well as other design, program and construction management professionals. It has more than 500 offices across 40 countries, on five continents.

Stock performance: We last reviewed this company in November, at which time it appeared to be in a position to profit from the new Liberal government's promise to boost infrastructure spending. However, six months have passed since then and no cohesive program has emerged from Ottawa. As a result, investors have backed off the stock, which is down about $6 from the November update.

Recent developments: Last month the company reported first quarter revenue of almost $1.5 billion, up 5.6% from the same period last year. However, most of the increase was from acquisition growth and did not

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Stock updates – continued from page 6…

translate into increased earnings per share. Adjusted net earnings came in at $33.1 million ($0.33 per share), which was about even with the year before.

CEO Pierre Shoiry said he was pleased with the results in what is typically the company's softest quarter of the year but investors clearly were not impressed, and drove the stock down. We need to see a period of renewed growth before they'll be back.

Dividend: The company pays a quarterly dividend of $0.375 per share ($1.50 per year), with the next payment due in mid-July. The drop in the share price has pushed the yield to up to 3.8%.

Action now: Hold. We need to see a couple of quarters of increased profitability before we give a new buy signal.

GORDON PAPE'S FUND UPDATES

iShares 1-5 Year Laddered Corporate Bond Index ETF (TSX: CBO)

Originally recommended on June 11/12 (#21220) at $20.24. Closed Friday at $19.18.

Background: This exchange-traded fund tracks the performance of the FTSE TMX Canada 1-5 Year Laddered Corporate Bond Index, net of expenses. The index measures potential returns of a portfolio of Canadian corporate debt securities based upon five distinct equally weighted annual groupings of maturity. The portfolio is laddered, meaning that securities holdings are scheduled to mature in a proportional, annual sequential pattern. Because of its short-term nature, this is regarded as a low-risk security.

Recent developments: This fund has been profitable for us once the distributions are taken into account but I have been concerned by the recent loss in net asset value (NAV). It means the managers were not earning enough to cover the current pay out level plus expenses. However, since my last review in January, the distributions have dropped somewhat and the NAV has increased slightly, which suggests the fund is back in balance. Since that time, we have received monthly distributions totalling about $0.25 per share while the trading price has increased by $0.09 for a total return of 1.8%. That may not seem like a lot but for a low-risk fund such as this it is very acceptable.

Action now: The fund is a Buy for conservative investors.

iShares Canadian Universe Bond Index ETF (TSX: XBB)

Originally recommended on March 5/07 (#2709) at $29.44. Closed Friday at $32.69.

Background: This ETF seeks to replicate the performance of the FTSE TMX Canada Universe Bond Index, net of expenses. The index consists of a broadly diversified selection of investment-grade Government of Canada, provincial, corporate, and municipal bonds issued domestically in Canada and denominated in Canadian dollars.

Recent developments: The anxiety stirred up by the Brexit vote gave a big boost to bond prices around the world and this fund benefited. The trading price is up by $1.19 from the time of our last review, when the units were trading at $31.50. As well, we received distributions totalling about $0.37 for a total return of almost 5% in the period. The 10-year average annual compound rate of return is 5.34% (to June 30). The management expense ratio is 0.33%.

Action now: Buy.

iShares Convertible Bond Index ETF (TSX: CVD)

Originally recommended on Sept. 29/14 (#21435) at $19.55. Closed Friday at $18.80.

Background: This ETF tracks the performance of the FTSE TMX Canada Convertible Bond Index. Only bonds traded on a Canadian exchange are eligible for inclusion and they must be denominated in Canadian dollars. Convertibles theoretically give investors the best of both worlds: regular interest payments plus an opportunity to earn a capital gain if the price of the underlying stock rises.

Recent developments: The units have rallied strongly since my January review, at which time they were trading at $17.26. Since then, they have rebounded by $1.54 and we have received distributions of about $0.38 per unit for a return of 11% during the period. This ETF is really hot right now, gaining 7.59% in the first half of this year.

Action now: Buy.

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