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The Internet Wealth Builder

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THE BIG SHORT

By Gordon Pape, Editor & Publisher

I don't watch many movies but the other day I got around to seeing "The Big Short". If you're not familiar with it, it's the story about how a few men identified in advance the fraud implicit in the mortgage-backed securities (MBS) scheme that led directly to the near collapse of the global financial system in 2008.

Naturally, no one believed these guys when they tried to borrow money to short the MBS market (which in itself was a challenge since at the time there was no way to do that.) They finally got the money, succeeded in finding a way to short the securities, and in the end made millions when the meltdown they predicted became reality.

Flash forward to now and another "Big Short" opportunity has presented itself. It's nowhere near as complex as the MBS scandal; in fact, it's right there for everyone to see. It would be the election of Donald Trump as President of the United States. Should that happen, shorting the S&P 500 (buying put options on the index) would likely make you a lot of money.

That may seem like a strange thing to say. Mr. Trump is a businessman after all and many of his policies would favour large corporations. He wants to cut the U.S. corporate tax rate from 35% to 15%. He would give the go-ahead to TransCanada's Keystone XL pipeline and, presumably, other such projects that require the government's approval. He would revive the coal mining industry. His climate change stance (he doesn't believe in it) would lead to a watering down or even elimination of many of the regulations that hamstring businesses.

Surely all this and more would be great for Wall Street, even if devastating to the environment, right?

Yes, that's true to some degree. But other aspects of his policies would, if implemented, lead to financial chaos that would almost certainly plunge the U.S., and the world, into a new recession, if not depression.

Look at his trade agenda. He wants to tear up NAFTA, which he calls the worst trade agreement in U.S. history (interestingly, it was negotiated under the watch of another Republican, President George H.W. Bush). He wants to build tariff walls that would impose punitive taxes on imports from countries like China and Mexico (and presumably Canada by extension although he never mentions us).

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The big short – continued from page 1…

The global trade wars that would result from such actions would carry us back to the depression era of the 1930s. They would not bring back prosperity to the U.S. heartland. But they would lead to a resurgence of inflation, which has been kept down in part because of low-cost imports from abroad.

But there's more going on here than Mr. Trump's anti-trade rhetoric. Based on his own words, his administration would attempt to undo 75 years of history, with totally unforeseen consequences. He has disparaged NATO. He appears to advocate nuclear weapons for countries like Japan and South Korea. He is contemptuous of numerous minority groups (e.g. Muslims, Mexicans), in violation of the U.S. Constitution. He condones mass bombings and the use of torture. He despises the media. He wants to get cosy with Vladimir Putin. He believes the U.S. voting system is rigged. He has threatened to jail Hillary Clinton.

The massive uncertainty that would be unleashed if he should be elected on Nov. 8 would be unequalled in U.S. political history, especially if the Republicans retain control of Congress. For the first time, the country would face the imminent danger of a virtual dictatorship and a police state. Investors would, quite rightly, flee for the hills.

Let's hope this scenario never unfolds. But let's not fool ourselves. Many Americans are angry and frustrated with the failures of their political leaders to address their issues. They see Trump as their saviour and nothing, it seems, will shake them. As he himself once said, he could stand in the middle of Times Square and shoot someone and he wouldn't lose a vote. That's how desperate some of his supporters are.

Thankfully, it now appears that Trump's campaign is in the process of self-destructing. But never say never. The unthinkable is happening more frequently these days (remember the shock of Brexit?). Hope for the best, but be prepared to act quickly if the worst happens.

When I was in university, I took a literature course that included the great Irish poet W.B. Yeats. He might have been writing about the Trump campaign when he penned one of his greatest poems, "The Second Coming". It begins with these lines:

Turning and turning in the widening gyre
The falcon cannot hear the falconer;
Things fall apart; the centre cannot hold;
Mere anarchy is loosed upon the world,
The blood-dimmed tide is loosed, and everywhere
The ceremony of innocence is drowned;
The best lack all conviction, while the worst
Are full of passionate intensity.

The final lines foretell the danger we now face:

And what rough beast, its hour come round at last,
Slouches towards Bethlehem to be born?

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SOMETIMES, RISK ARRIVES OUT OF LEFT FIELD

Contributing editor Shawn Allen back is with us this week. Shawn has been providing stock picks on his website at www.investorsfriend.com since the beginning of the year 2000 and has a great success record. He is based in Edmonton. Here is his report.

Shawn Allen writes:

Recent developments at Wells Fargo illustrate the inescapable fact that very negative events are often things that companies and investors simply did not or could not see coming.

Wells Fargo has rather suddenly become embroiled in a huge scandal. On Sept. 8 it announced that it has reached a legal settlement to pay $185 million in fines in regards to customers receiving products and services, dating back to 2011, that they did not request. The announcement indicated that *"$2.6 million has been refunded to customers for any fees associated with products customers received that they may not have requested"* and that managers and team members who had acted counter to the company's values had been terminated. The announcement also indicated that various changes were being made to sales practices and training.

At that point, Wells Fargo probably believed that this matter was an embarrassment but did not view it as a major scandal. After all, a $185 million dollar fine represents less than four cents per share. And the $2.6

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Risk – continued from page 2…

million in improper fees to customers is very small in relation to Wells Fargo's $86 billion in annual revenues. The market initially agreed as the price declined by only 1.7% on Sept. 9.

However, in the brief few weeks since this story first broke the following has occurred:

- It quickly became known that the number of unauthorized account openings was about two million, dating back five years, and that some 5,300 employees had been fired over the matter but no senior executives.
- On Sept. 20, the CEO (John Stumpf, who was also the chairman of the board) testified before the U.S. Senate where he was accused of "gutless leadership" and it was suggested he should be terminated and then criminally investigated. The bank's cross-selling and sales management processes were severely criticized, and even vilified.
- On Sept. 23 the company announced that all retail sales goals would be eliminated effective Jan. 1, 2017.
- On Sept. 27, Wells Fargo announced that its board would conduct an independent investigation into all sales practices, that the CEO had volunteered to forfeit $41 million in unvested stock options and would receive no pay during the investigation and no bonus for 2016, and that the head of community banking had left the company and would receive no severance and would forfeit $11 million in unvested options and receive no bonus for 2016.
- On Sept. 29, the CEO testified before the House of Representatives and was accused of greed and incompetence and the bank was accused of theft. The company also announced that all retail sales goals would now cease as of Oct. 1.
- On Oct. 12, the CEO retired and the chief operating officer was promoted to the CEO position and the lead director was named chairman of the board.
- Various investor class action lawsuits have been announced.
- State and city administrations in California, Ohio, Chicago, and Seattle have announced they will cease issuing debt through Wells Fargo.
- As I write this, the share price is down 10.5% since Sept. 8.

In summary, the unauthorized accounts problem at Wells Fargo quickly went from being an embarrassment to an extremely major event.

It seems clear that management had not identified this matter as a major risk. In its 2015 annual report, Wells Fargo devoted 44 pages to the topic of "Risk Management". Not a single word in this section was devoted to mentioning sales practices or cross selling as a risk. In other areas of the annual report the words "cross-sell" occur 20 times and not once is it identified as a risk. And this is despite the fact that the CEO acknowledges that he has been aware of issues with unauthorized account openings since 2013. Plus, it seems likely that the investigations that led to the Sept. 8 settlement of $185 million was well under way by the time the 2015 annual report was published.

It is true that there had been public rumblings about high-pressure sales tactics at Wells Fargo. But I don't recall any rumblings about unauthorized accounts. And, overall, it seems clear that investors viewed cross selling positively because it had contributed to growth over the years. Investors did not see this risk coming.

My belief is that Wells Fargo management vastly underestimated the reputational risk that the unauthorized account opening matter represented. I don't think they hid the risk; rather they failed to comprehend it.

Wells Fargo fell victim to the law of unintended consequences. Their sales practices and sales goals contributed to the success of the company. But they failed to anticipate and guard against the incentive that employees had to meet the sales goals by opening unauthorized accounts.

When the unethical practices first came to light, it appears that Wells Fargo management could not accept that the practice was widespread because that simply went against their strongly held view of themselves as running a highly ethical operation.

For investors, risk is primarily the possibility of a temporary or more permanent decline in the market value of an investment or the annual cash flows received.

By its nature, risk is uncertain and cannot be measured with any precision. In addition, many risks that have only a very small probability of occurring can have a devastating impact if they do happen. (Somewhat like the risk of a person getting hit by lighting.)

For investors, the first line of defense against risk is to

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Risk – continued from page 3…

diversify across asset classes, geographical areas, and individual companies.

When it comes to individual companies, investors can attempt to assess the risks, although it is difficult, as the Wells Fargo experience shows. Annual reports include an explanation of the major risks as perceived by management. However, my experience is that such discussions of risk consists of "boiler-plate" material and may not reveal the most important risks. For example, I have never seen a company mention that its management could be incompetent or unethical or vastly over-paid. Yet those are important risks.

At IWB, most of our recommendations include a discussion of risks. By turning our minds to risks we are able to identify the more important risks in many cases. However, by their nature, some risks will forever come as a total surprise when they occur. For that reason, diversification should always be a part of your strategy as an investor.

SHAWN ALLEN'S NEW STOCK PICK

I have a new recommendation for you today. It's CRH Medical Corporation (TSX: CRH, ASE: CRHM). Here are the details.

Background: CRH is a medical products and services company founded in 2001. However, despite the head office being in Vancouver and despite trading primarily in Toronto, investors should view this as a U.S. company since all of its revenues and the great majority of its costs occur in the U.S. All the figures that follow are U.S. dollars except as noted.

The company began trading in Canada in 2003 and listed on the American Stock Exchange in 2008. This is a small firm with only 16 full-time employees plus over 50 contracted personnel. Annual revenues are running at $56 million.

Financials: In the first half of 2016, 83% of revenues were derived from its anesthetic services business. The company provides these for gastrointestinal endoscopic procedures on an exclusive contract basis to ambulatory (walk-in) surgical centers. At the end of 2015 the company provided these services at 18 surgery centers.

The remaining 17% of revenues were derived from the company's longer standing business of providing gastrointestinal physicians with a patented single-use disposable hemorrhoid banding product. The company markets direct to physicians and at the end of 2015 had trained 2,175 physicians in 811 clinical practices to use its banding system

Share performance: The share price is up about 40% in 2016 to date and displays a rising trend.

Recent developments: Starting in late 2014, the company raised substantial amounts of debt and equity capital and greatly expanded the revenue and scope of the business through a growth-by-acquisition strategy.

Its December 2014, $66 million acquisition of an anesthetics business for cash (plus a modest contingent component) was transformative as assets of the company increased from $11 million to $79 million. An equity issuance (and a smaller follow up issuance in early 2015) increased the share count by 51% and substantial debt was issued.

This was followed by the acquisition of from 51% to 100% of four anesthetic companies in 2015 for cash totaling $19 million, financed largely by debt plus a modest equity issuance. In the first half of 2016 the company purchased 51% to 65% of three additional anesthesia service providers for a total of $34.5 million paid by cash (and deferred cash in one case). The purchases were financed largely with debt.

Dividend policy: This company does not pay a dividend as it retains all earnings to help fund its growth-by-acquisition strategy.

Valuation: At the Oct. 17 closing price of C$5.96, the price to book value ratio, in isolation, is not attractive at 6.3 and the tangible book value per share is negative. And, based on earnings adjusted to add back the amortization of intangibles and to eliminate currency gains and losses, the p/e ratio is ostensibly not attractive at 38. However, revenues and earnings per share have recently been growing very rapidly. And, the adjusted ROE (return on equity) is very strong at 18%. The stock

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New stock pick – continued from page 4…

is "pricing in" considerable growth. Overall, the value ratios, in isolation, are inconclusive.

Outlook: The company appears set to continue growing through acquisitions.

Risks: The annual report lists many risks including operational and competitive risks. In our view the more important risks would include potential medical liability and regulatory risks.

Conclusion: The thesis in buying this company is to participate in the expected growth through acquisition.

Action now: The stock is a Buy for investors willing to accept the risks associated with this small company. The shares closed Friday at C$6.19, US$4.64.

SHAWN ALLEN'S UPDATES

Canadian Western Bank (TSX: CWB, OTC: CBWBF)

Originally recommended on Sept. 15/14 (#21433) at C$40.54, US$36.31. Closed Friday at C$25.45, US$19.10.

Background: This is a western Canada regional bank with 42 branches. It also has non-branch-based lending activities in the eastern provinces that account for 16% of its loans. Alberta accounts for 40% of its loans, B.C. 35%, and Saskatchewan and Manitoba together account for 9%. Ontario and other provinces account for the remaining 16%.

While the large Canadian Banks derive a significant portion of revenues and profits from non-lending activities, CWB is almost entirely a traditional "spread" lender, taking in deposits and lending those out at a higher rate. Its small non-lending operations include trust and wealth management services, which constitute only 4% of revenues.

CWB primarily lends to commercial customers. The bank's loan book is only 16% personal mortgages and loans of which half are alternative mortgages sourced through a broker network. The remainder of the loan book consists of 19% commercial loans, 19% commercial mortgages, 19% equipment financing, 18% real estate project, 6% larger syndicated corporate loans, and 2% oil and gas production loans.

Deposits are 34%, sourced from in-branch accounts and 19% in-branch term deposits (totaling 53% in-branch), 38% retail term deposits sourced from the (higher interest cost) third party broker network, and 9% from deposit bonds sold to investors. Deposits are 58% personal and 42% commercial or investor. Some 66% are term deposits, meaning they can't be withdrawn on short notice.

Recent developments: In the second quarter, CWB made a relatively large provision for loan losses associated with loans to oil and gas production companies. In the third quarter there was an additional but smaller provision and some of the impaired oil and gas loans were written off.

The bank recently made two acquisitions that will result in more of its lending being in Ontario. It launched a new core banking system in the third quarter that will enhance customer service and products and (in summer 2019) will allow increased leverage under banking regulations. It opened its 42nd branch in the quarter. It issued a modest amount of shares (despite a low share price) to shore up the balance sheet in the face of possible credit losses.

CWB's earnings per share were down 13% year-over-year in the latest quarter, which was an improvement from the decline of 40% in the prior quarter due to a large provision for losses related to oil and gas production loans. Management appears to be confident that loan losses will remain manageable, although higher than in recent years.

Dividend: The stock pays a quarterly dividend of $0.23 ($0.92 per year) to yield 3.6%.

Valuation: At my analysis price of $24.83, the price to book value ratio seems very attractive at 1.02 (price to tangible book value is also very attractive at 1.11). The trailing adjusted p/e also looks good at 10.1. The dividend yield is attractive at 3.7% and reflects a payout ratio of 40% of adjusted earnings. The adjusted ROE is reasonably good at 10% for the latest four quarters. Intrinsic value per share is calculated as $33, assuming 5% average annual growth for five

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Shawn Allen's updates – continued from page 5...

years and a terminal p/e of 13. These ratios in isolation would indicate a Buy rating.

Risks: Banks, by nature, have very high leverage ratios and there is a large potential for losses if poorly managed. The high leverage means that a small decline in revenues or a small increase in bad loans can chew through earnings very fast.

If lower oil prices were to lead to a severe and prolonged recession in Alberta affecting the wider economy and perhaps leading to a population decline, then CWB could face very significant loan losses.

As well, being primarily a regional bank, CWB cannot manage its risk through geographical diversification. However, the company has been profitable for some 113 consecutive quarters including during several previous recessions.

Outlook: Earnings in the fourth quarter will very likely be lower than 2015 with the size of the decline depending on the level of contagion of losses from the direct energy production loans to the equipment financing and other loan categories. The long-term outlook for growth remains good but that depends on a recovery in the Alberta economy.

Action now: Buy, based on the attractive valuation and the strong history of profitability even in recession conditions.

Toll Brothers (NYSE: TOL)

Originally recommended on Nov. 11/13 (#21340) at $31.94. Closed Friday at $28.53. (All prices in U.S. dollars.)

Background: Toll Brothers is primarily a land developer and builder of executive and luxury homes. Its average home price is about $700,000 in most of its regions. In California, its average home price is much higher at $1.5 million.

The company operates in 19 states in four regions of the U.S. It has 3,900 full-time employees. It also has other businesses of increasing importance, including selling lots to other builders, building luxury high rise condos in large cities, and building and renting apartment units in selected large cities.

Stock performance: TOL's share price fell substantially from about $36 in December to as low as the $24 range in early February. The stock has now recovered to above $28. The company responded to the price drop by aggressively increasing its share buy-back program.

Recent developments: Earnings per share were up 41% in the latest quarter. Earnings have been rebounding, albeit with volatility, in line with the recovery of the U.S. economy, American home prices, and new home starts. Toll's adjusted earnings were up 7.6% in 2015 after doubling in fiscal 2014. Signed contracts were up 18% in the latest quarter.

U.S. home building starts declined in August but an index of homebuilder confidence was at an 11 month high in September.

Valuation: Analyzed at Monday's closing price of $28.41. The p/e ratio is 11.8 and the price to book value ratio is 1.18. Return on equity (ROE) is 10.4% and has been rising, albeit with some volatility, for several years with the housing recovery. In isolation, these ratios would suggest a Buy rating.

Risks: In my view, the main risk is that the recovery in single-family home starts and prices in the U.S. fails to continue or reverses course.

Outlook: Based on existing signed contracts we would expect growth in revenues of about 19% or more in the next year as the backlog is up 19%. Earnings growth is harder to predict as costs will rise along with revenue but should be at least 15% and could be closer to 25% given economies of scale and assuming similar gross profit levels.

This company is unusual in that the 9-12 month lag between contracting to build a house and delivering that house means that the revenues are quite predictable in the year ahead.

Dividend: The stock does not pay a dividend.

Conclusion: The overall thesis in buying Toll Brothers is that it is a well-managed company selling at a somewhat discounted price, and provides a way to benefit from the continuing recovery in U.S. home building starts and prices.

Action Now: Buy.

- end Shawn Allen

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GORDON PAPE'S MUTUAL FUND UPDATES

Templeton Growth Fund (TML700)

Originally recommended on July 22/13 (#21327) at $12.35. Closed Thursday at $16.66.

Background: This is a global equity fund, which means it can invest in stocks from any country in the world. As of the end of September, 36.5% of the assets were in the U.S., 11.3% were in Great Britain, 7.3% were in Japan with the same percentage in France, and the rest were scattered.

Fund performance: The fund is coming off a weak year, with a gain of only 3.1% for the 12 months to the end of September. That was well below average for the peer group.

However, it has looked better recently, gaining 9.1% in the most recent three-month period. The three-year average annual compound rate of return (which covers the approximate period since it was recommended) is 9.3%.

Distributions: Virtually none. The fund is supposed to make annual capital gains distributions but the last payout was in June 2015 and the amount was only $0.0119 per unit. There were no distributions in the three years prior to that.

Key metrics: At one time this was the largest mutual fund in Canada but those days are long gone. Current assets under management are just under $1.5 billion, still substantial but nowhere near the top rank. The management expense ratio (MER) is 2.46%. The minimum initial investment is $500.

Analysis: International stocks have been soft and the fund's performance over the past 12 months reflects that. It's especially concerning that the fund underperformed its peer group by a wide margin during that period. It's reasonable to pay a high MER for an outstanding performance but not for a sub-par return.

Outlook: The fund's heavy weighting in the U.S. may help to boost return in the coming months but I will be watching it closely. If it continues to lag, we'll dump it.

Action now: Hold for the time being.

TD Advantage Balanced Income Portfolio (TDB2060)

Originally recommended on Feb. 13/12 (#21206) at $11.01. Closed Thursday at $12.55.

Background: This is a conservatively managed balanced portfolio that invests in the units of other TD funds.

Fund performance: At the time I recommended it, I suggested this fund is best suited to low-risk investors who are prepared to sacrifice some growth potential for a higher degree of safety. The results are in line with this approach. The fund returned 5.56% over the year to Sept. 30, slightly below average for the category. However, over the three years to that date, the average annual return of 6.11% is slightly ahead of the peer group.

Distributions: The fund pays very small quarterly distributions (often less than a penny per unit) plus a year-end capital gains payment. It is not suitable for investors who require regular cash flow.

Key metrics: About 60% of the assets are invested in the TD Canadian Core Plus Bond Fund, with the rest spread among various equity funds. The fund has an MER or 1.95% and the minimum initial investment is $2,000.

Analysis: The fund has never posted a losing calendar year since it was launched in 2009 and the large bond weighting will continue to provide a cushion when stock markets decline.

Outlook: More of the same. This is a stable portfolio that provides some growth potential with minimal risk.

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

Steadyhand Founders Fund (SIF125)

Originally recommended on Feb. 25/13 (#21308) at $10.73. Closed Thursday at $12.71.

Background: This is a portfolio fund that invests in the five funds offered by the small Vancouver-based Steadyhand boutique house. Company founder and CEO Tom Bradley decides the composition of the portfolio

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Mutual fund updates – continued from page 7…

using a tactical asset allocation approach.

Fund performance: Over the year to Sept. 30, the fund gained 7.21%, almost exactly the same as the category average. The three-year average annual compound rate of return was 6.82%, which was 31 basis points better than the average.

Distributions: The units distribute $0.045 per quarter plus there is a year-end capital gains payment in December.

Key metrics: This is a small fund, with about $289 million in assets under management. The MER is a very reasonable 1.34%. You'll need a minimum initial investment of $10,000 to take a position. The fund is not available to investors in the Territories or in provinces east of Ontario.

Analysis: Steadyhand has built its reputation on low fees and a conservative style. The fund holds a mix of about one-third bonds and two-thirds cash that should protect investors from major losses. Tom Bradley is one of most intellectual and respected managers around.

Outlook: I expect this fund to continue to deliver returns in the 5% to 7% range.

Action now: Buy.

Steadyhand Income Fund (SIF120)

Originally recommended on Jan. 23/12 (#21203) at $10.56. Closed Thursday at $11.28.

Background: This is primarily a bond fund with a small equity component, usually 20-25% of the portfolio.

Fund performance: After a weak year in 2015 (gain of only 0.83%) the fund has come back strongly this year with a year-to-date gain of 6.88% to Oct. 19. The three-year average annual compound rate of return to Sept. 30 was 6.9%.

Distributions: The fund currently pays quarterly distributions of $0.045 per unit plus a year-end capital gains pay-out.

Key metrics: The assets under management are $98 million. The MER is a very low 1.04%. The minimum investment is $10,000 and the same geographic limitations apply as those of Steadyhand Founders.

Analysis: The fund is managed by Connor, Clark & Lunn, a Vancouver-based company known for its conservative approach. It's one of the best fixed-income balanced funds around.

Outlook: This year's return is higher than one would normally expect from a fixed-income weighted fund. Gains in the 4-6% range appear more probable going forward.

Action now: Buy.

MEMBERS' CORNER

Luxor placement

Member comment: I was surprised to see details of a private placement for Luxor at $0.30 per unit when a recent IWB recommendation mentions nothing of this at all. Was this factored into the recommendation?

I note the stock has fallen back from $0.39 to $0.35, probably due to this placement. Should I be paying more than $0.30 if I wish to make an investment at this time?

- Brian B.

Ryan Irvine replies: The private placement was not announced until after our recommendation, which was made in the issue of Sept. 26. The announcement was made on Sept. 30. Unless we had access to non-public material (which no analyst should as it is illegal to act on) we could not have known about a future financing such as the one in question.

The placement is not out of the ordinary for growing public companies. We would have liked to have seen the price closer to the trading price at the time, but the stock has been on a steady rise and $0.30 is not out of its range over the last several months.

We continue to see the company as a Speculative Buy as 2017 is expected to show further growth.

The stock is currently at the $0.34 level.

– R.I.

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