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## BUILDING WEALTH

The Internet Wealth Builder

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## TRUMP SHOULD KNOW BETTER

*By Gordon Pape, Editor and Publisher*

You'd think that for a businessman, Donald Trump would know more about the stock market. But it seems not, at least based on his Twitter comments last week.

The U.S. president berated investors for selling off their shares in the wake of good economic news. Jobs are being created. Wages are rising. What were they thinking? It wasn't like that in "the old days" he complained.

I'm not sure what "old days" he was referring too. I'm older than he is and I have written many times over the years on why stocks often sell off despite good economic news. The reason is simple: good news implies higher interest rates and a possible resurgence in inflation, both of which can spell trouble for stocks.

The plain fact is that stocks have been overvalued for too long, especially in the U.S. market. We did not have a single correction (a downturn of over 10%) in 2017, which is extremely rare. The last one was two years ago, at almost exactly this same time.

The reality is that two years without a correction lulled us into slumberland. People got used to the markets hitting one new record after another and, as often happens in such situations, started to believe it would never end.

In the first issue of this year, I predicted that U.S. stocks would move higher initially, followed by a correction of 10%+. That wasn't a genius call. Anyone who watches the market closely could have come to the same conclusion. The real surprise was that it took so long to happen.

There is one important thing to keep in mind about what's happening: there is no evidence of any structural change, at least not so far. No big companies have collapsed (remember Bear Stearns and Lehman Brothers?). The central banks aren't panicking – no talk of interest rate drops; quite the opposite in fact. This is not looking at all like 2008. It's a simple market correction; we have had them before and we will again.

Even with this month's sell-off, prices are still at lofty levels, so I would be cautious on committing new cash at this point. Let's wait for the current volatility to run its course and then zero in on quality companies that have slipped back to more reasonable prices.

In the meantime, don't panic and sell into the downturn. Corrections are a normal part of the market's ebb and flow. Assuming you have constructed a good quality portfolio that is suitable to your risk tolerance level, just ride out this setback and be ready to take advantage with new purchases when the time is right.

# WHAT NOW FOR STOCKS?

By Vitaliy N. Katsenelson, CFA

I've been asked to comment on the most recent market decline. My initial reaction was: markets go up and they go down. America is a great country, but the U.S. Constitution doesn't guarantee always-rising markets. I sat down, and I wanted to write a reassuring message. I wanted to express my empathy. Somehow, I found that my reservoir of empathy was empty: After the recent decline the market is still up twenty-something percent from the beginning of 2017. And then I stumbled on Dalio and Wilson predicting what the market will do next and I have to confess I started writing and could not stop. (I apologize ahead of time for the rantiness of this message.)

- *Ray Dalio: Cash on the sidelines will pour in to stem the bleeding in this market.*
- *Morgan Stanley's Wilson warns investors not to buy the dip.*

Two contradictory headlines on the MarketWatch home page, right next to each other.

Do you listen to Dalio or Wilson? I want to let you in on a small Wall Street secret: Neither Dalio nor Wilson knows what the stock market will do next. Don't be fooled by their fancy pedigrees, the gazillions of dollars they manage, the eloquence of their logic, the myriad of data points they marshal. Nobody, but nobody, knows what the stock market will do tomorrow, next week, or next year. Stock market behavior in the short term is completely random. Completely! You'll have better luck predicting the next card at a black jack table than guessing what the stock market will do next.

The media, of course, needs to fill pages and rack up views, and so there are gazillions of explanations (I'm trying to use the word gazillion at least three times in this article) for why the stock market does this or that. The explanations always sound rational, but for the most part they are worthless because they have zero forecasting power. A strong jobs report sent stocks up. Explanation: The economy is doing great. A strong jobs report sent stocks down. Explanation: Investors are worried about higher interest rates. I can give a dual spin to any news, maybe only short of nuclear war.

My biggest problem with "The stock market will do this" headlines is that they turn investors into degenerate gamblers. I see people trying to treat the stock market like a casino. They get lucky at times and catch the wave of randomness (especially if the market marches higher every

single day). Success goes to their heads, they feel like they've got this whole stock market thing figured out. Stocks are just bits of data that are priced on the exchanges gazillions of times a day. This is not investing – I don't even want to insult gambling by calling it gambling. At least gamblers don't gamble with their life savings and 401k's (unless they are degenerate gamblers). (Note: 401k is the equivalent of a Canadian RRSP.)

So, what will the stock market do next? It's the wrong question. It's the question that should never be asked, and if asked should never be answered. Asking this question shows that you believe there is some kind of order to this random madness. There is not. And if you answer with any answer other than "I don't know," you're a liar.

How do you deal with market declines? Stop looking at the market as if it were a casino and start treating stocks as businesses that you are trying to buy at a discount to fair value. Stock price is an opinion of what the market is willing to pay for this business right now. Yes, it's an opinion, not a final judgement. The stock market is going to be a miserable place for you in the long run if you take market opinions on any given day seriously and treat them as final judgements.

If you start treating stocks as businesses and you start analyzing them and valuing them as such, then market drops stop being a source of pain and turn into a source of pleasure. I read somewhere that most money is made during bear markets (when you buy stocks on the cheap) – it just doesn't feel that way at the time. Even if you are fully invested (we are not) why does it really matter that the market decided to price your stocks lower today (unless you believe the market is right)? Will it matter three, five years from now? If you own undervalued companies, they may get more undervalued before they become fully valued. As long as you've got the valuation right, you'll eventually be proven right.

Let me tell you what we did when the market took a dive. We looked at stocks we owned and asked ourselves a question: Had their values changed? They had not. Then we asked if we wanted to increase our positions in any of them. Then we looked through our long watch list to see if any stocks had hit our buy-price targets. That was it. That is the only rational way to invest. Anything else is...

Vitaliy N. Katsenelson, CFA, is Chief Investment Officer at Investment Management Associates in Denver, Colorado (<http://imausa.com>).

## STOCK VALUATIONS ARE TOO HIGH

Contributing editor Ryan Irvine joins us this week with his views on the recent market turbulence and a new stock recommendation. Ryan is the CEO of KeyStone Financial ([www.KeyStocks.com](http://www.KeyStocks.com)) and is one of the country's top experts in small caps. He is based in the Vancouver area. Here is his report.

### Ryan Irvine writes:

Broadly speaking, the markets are pricy.

In fact, this past weekend I talked to over one thousand investors and tried to drive home that very point. I do not like the valuations on the broader market and would not buy "the market" at current prices. Investors' optimism, often a contrarian indicator, had reached a fever pitch and, perhaps most significantly, broader valuations are lofty from a historical perspective.

Most of you are familiar with the p/e (price/earnings) ratio used to value a stock. It is the ratio for valuing a company that measures its current share price relative to its per-share earnings. If a company were currently trading at a multiple (p/e) of 20, the interpretation is that an investor is willing to pay \$20 for \$1 of current earnings.

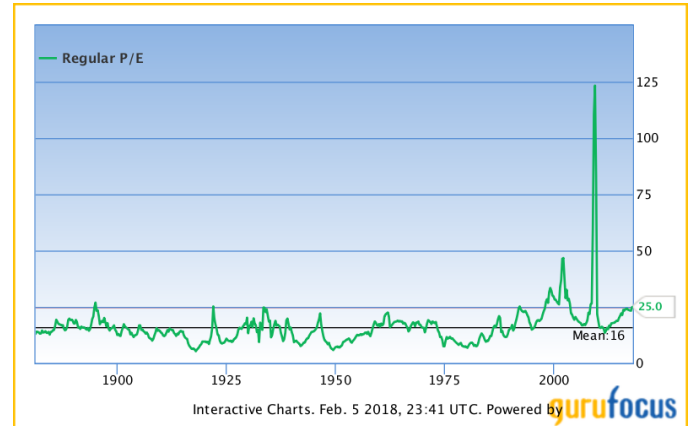
It has its limitations but can be useful when valuing a stock. We can also use an overall market p/e to value a broad index such as the S&P 500 – the largest 500 stocks in the US.

For context of where the market is generally, we like to look at the Shiller p/e. Developed by Yale Professor Robert Shiller, the Shiller p/e is a more reasonable market valuation indicator than the normal p/e ratio because it eliminates fluctuation of the ratio caused by the variation of profit margins during business cycles.

The Shiller p/e is calculated by using the annual earnings of the S&P 500 companies over the past 10 years. There are a few other calculations in the mix, but for the purposes of a quick commentary, we do not want to get too complicated.

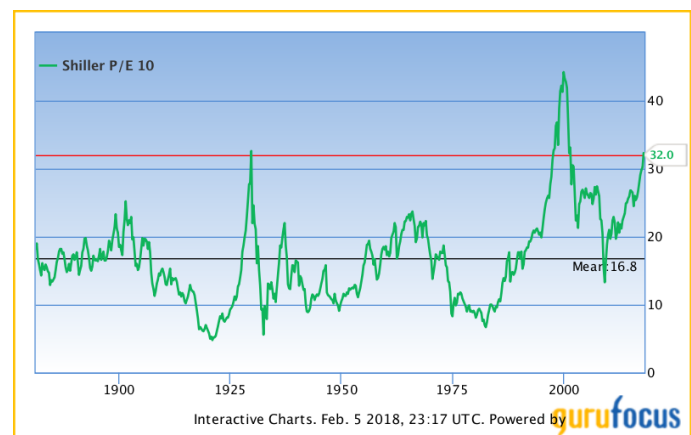
When we look at the historical performance of the S&P 500, it becomes apparent how using regular p/e ratios distorts results.

Take a look at this chart:



This chart shows us the "regular trailing 12-month p/e" over the last 130+ years. Currently, based on the last 12 months of earnings in the U.S., the p/e is 27 – well above the mean of 16, but well below some of its highs.

The highest peak for the regular p/e was 123 in the first quarter of 2009. By then the S&P 500 had crashed more than 50% from its peak in 2007 (financial crisis). The p/e was high because earnings were depressed (not due to high historical valuations). With the p/e at 123 in the first quarter of 2009, much higher than the historical mean of 15 – it looked like a time to sell. In fact, it was the best time in recent history to buy stocks. On the other hand, the Shiller p/e was at 13.3 (see the chart below), its lowest level in decades, correctly indicating a better time to buy stocks.



So where are we today?

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**Stock Valuations – continued from page 3...**

As I write, the Shiller p/e is 32 or 90.5% higher than the historical mean of 16.8. It is currently far closer to its historical high of 44.2 hit in the “Dot Com” boom, than its historical low of 4.8.

We do know that even if stocks stay in their same range, the new tax regime will cut p/e ratios next year (as would negative price action on the S&P 500). But U.S. markets are certainly at the high end of valuations.

In what has been is a frothy market, our best advice is to find good, unique companies and buy them with patience over a 12-18-month period. It is prudent to layer into positions – buy 25% or 50% of your full position to start and add over time.

One of the worse things you can do is buy your full portfolio all at once. By spreading out your purchases, it prevents you from buying at an annual peak in the markets. Investors should also refrain from jumping on a stock without doing proper due diligence, no matter how “blue-sky” its prospects may appear.

To be frank, I cannot tell you 10 screaming buys right now but if you give me a year, I will find them.

A correction, if that is what we are seeing in the markets, is difficult to stomach but likely necessary given the broader valuations and could be healthier long-term. If it continues, we may finally start to see more reasonable valuations surface and the bonus is our readers would likely see more recommendations moving forward.

## **RYAN IRVINE RECOMMENDS DYNACOR**

For IWB Readers and our long-term clients the next recommendation could appear strange at first glance.

After all, the company has “gold mines” in its name and KeyStone generally steers clear of junior mining stocks (even producers). We view them as great destroyers of capital rather than the capital creators and compounders that we prefer investing in. But now we are making an exception. Here are the details.

### **Dynacor Gold Mines Inc. (TSX: DNG, OTC: DNGDF)**

Headquartered in Montreal, with operations based in Peru, the company is engaged in the milling of gold through its government approved ore processing operations.

Dynacor’s activities consist of the production of gold and silver from purchased ore and the exploration of its mining properties located in Peru, with the potential for commercial extraction of gold and other precious metals.

The company purchases its ore from government registered ore producers from various regions of Peru and then processes it at its wholly-owned milling facility to produce gold and silver, which is sold internationally at market prices. Dynacor also owns the rights on three mining properties, which are in the exploration stage, including its flagship exploration gold, copper, and silver prospect, the Tumipampa property. It does not have any properties in commercial production.

So, what makes this different from other gold producers? The company operates a mill, not a mine.

The biggest risk to any junior gold miner is the price of gold. The second is often the deposit and/or the mine itself. Most are difficult to develop, produce inconsistent grades, have a finite supply, and provide a plethora of other issues. Even for experienced operators, they can be a very unpredictable.

Dynacor is different because it does not rely on one deposit. The company receives ore shipments from more than 400 government registered Peruvian artisanal gold miners (small-scale miners). As such, it has a diversified feedstock of ore and limited deposit-specific risk.

Once the ore is received, Dynacor weighs, assays, and screens deliveries for gold content at its new modern Veta Dorada Plant in Chala, Peru. The company then pays the small-scale miners after 24 hours from delivery and processes the ore through the mill.

In the final step, after 10-14 days of processing, Dynacor receives payment for gold ore bars from its recently announced strategic joint venture partner, PX Precinox. The gold is sold to some of the world's leading luxury jewelry and watch manufacturers, who are very keen to purchase socially responsible, traceable gold produced by artisanal miners. The buyers of PX Impact Gold (joint venture) pay a small premium that is then used to fund socio-economic development projects in Peru for artisanal miners and their communities.

**Financial results:** Dynacor recently posted its twenty-

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**Dynacor – continued from page 4...**

sixth consecutive quarter of profits. This is rare for a gold related-business. On Jan. 9 the company announced final payments on debt facilities were completed at end of December. Over the last five months of 2017, Dynacor made aggregate debt payments of \$6.3 million, all from cash flow, putting the company in a solid net cash position.

On Jan. 18, the company announced gold ore processing was running at full capacity of 300 tonnes per day (tpd). In January 2017, Dynacor processed 185 tpd, ending the year 62% higher at 300 tonnes per day. In December gold production reached an all-time record high of 8,908 oz., a 31% increase as compared to December 2016, when it was 6,803 oz.

Suffice it to say, the company is progressing well.

**Valuations:** Fair value estimates on commodity related businesses are generally flawed, given the unpredictable nature of most underlying commodities. As such, they should be considered to hold a higher degree of risk.

If the gold price remains relatively in its same range or moves higher over the course of 2018, Dynacor trades at a relatively attractive 4.16 times EV/2018 EBITDA. The

company also trades at roughly six times our 2018 cash flow estimate. At 10 times our expected 2018 cash flow we reach a fair value in the range of \$3.20, or 62%, higher than the current share price. The highest risks to the estimate are execution, weather, and the price of gold in 2018.

**Conclusion:** While Dynacor has been slow to ramp up to its 300 tpd target at the Veta Dorada Plant, once it was hit the company made short work of its outstanding debt and appears on a path towards significant potential growth in 2018. If it does not face the type of headwinds experienced at the hand of Mother Nature in 2018, the company should begin to build cash reserves over the course of the next year, positioning management to implement a dividend. This could put the company in front of a wider spectrum of potential investors.

While we tread very lightly in commodity-based businesses, the stock appears to offer good speculative value at present and provides a unique exposure to gold without the typical significant deposit-specific risk seen with traditional junior gold producers.

**Action now:** We recommend this stock as a Speculate Buy, which means it is only for aggressive investors who can handle risk. We would set limit orders in the \$1.90-\$2.05 range and be patient. The shares closed on Friday at C\$1.93, US\$1.56.

## **RYAN IRVINE'S UPDATES**

### **Meritage Hospitality Group Inc. (OTC: MHGU)**

*Originally recommended May 15/17 (#21719) at \$14.85.  
Closed Friday at \$19.90 (all figures in U.S. dollars).*

**Background:** Meritage Hospitality Group is one of the nation's premier restaurant operators, with 297 restaurants (290 Wendy's) in operation located in Arkansas, Florida, Georgia, Michigan, Missouri, Mississippi, North Carolina, South Carolina, Ohio, Oklahoma, Tennessee, and Virginia.

Management's successful strategy has been to consolidate the existing network of Wendy's franchises in North America through acquisitions and to improve sales and profitability of acquired restaurants through integration into its IT platform and restaurant remodeling.

**Performance:** The stock was recommended at \$14.85 and recently moved higher to close last week at \$19.90 following a significant acquisition and strong growth outlook.

**Recent developments:** On Jan. 31, Meritage announced it has acquired 38 Wendy's restaurants located in Connecticut and Massachusetts. The company funded the acquisition through a private placement of preferred stock, cash on hand, and debt financing provided by a syndicate of banks led by City National Bank. Meritage expects the 38 restaurants to add approximately \$75 million in annual sales and be accretive to earnings going forward.

The company also recently reported that it has agreed to purchase an additional 50 restaurants and is currently proceeding through the customary closing process. The acquisitions are consistent with the company's five-year growth plan to expand its operating base up to 400 Wendy's and 20 casual dining restaurants.

**Valuation:** Meritage's shares surged 85% in 2017. Despite this, with the company estimated to have earned \$1.35 per share in 2017, its price to earnings or p/e ratio is a relatively reasonable 15.55. The average market

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**Ryan Irvine's updates – continued from page 5...**

multiple for U.S. stocks at present is in the range of 20. Meritage trades at a significant discount to this, yet its growth rate is superior to the average stock on U.S. market. We call this GARP or growth at a reasonable price.

We estimate the company is positioned to earn \$1.69 per share in 2018. If we apply a multiple of 18 to this figure (18 x 2018 EPS of \$1.69) fair value could reach \$30 over the next one to two years. There is above average risk in the stock, but the management team continues to execute well.

**Action now:** We maintain our Speculative Buy rating on the stock.

**Sylogist Ltd. (TSX-V: SYZ, OTC: SYZLF)**

*Originally recommended Sept. 18/17 (#21734) at C\$8.83, US\$6.90. Closed Friday at C\$9.60, US\$8.17.*

**Background:** Sylogist is a technology innovation company which, through strategic acquisitions, investments and operations management, provides intellectual property solutions to a wide range of Public Sector customers.

The company publishes mission-critical software products that satisfy the unique and sophisticated functionality requirements of public sector entities, non-profit organizations, educational institutions, government agencies as well as public compliance driven and funded businesses. Sylogist delivers highly scalable, multi-language, multi-currency software solutions, which serve the needs of an international clientele.

**Performance:** The stock was recommended in September at \$8.83. It hit a high of \$10.80 in December and then pulled back a bit to the current level.

**Recent developments:** On Jan. 16 Sylogist reported its fourth quarter and full fiscal year 2017 financial results. We view them as positive. Here are the fourth-quarter highlights:

Earnings per share increased 13% to \$0.09 per share, up from \$0.08 per share in the same period of 2016. Adjusted EBITDA was \$3.2 million, an increase of 21%. Earning per diluted share were \$0.14, up 27% from last year.

Revenues were \$8 million compared to \$8.1 million in the fourth quarter last year. Cash generated from operations totaled \$1.6 million, up from \$343,000 a year ago. Cash as at Sept. 30, 2017 totaled \$28.8 million. The company has no debt.

**Conclusion:** We viewed 2017 as a transitional year which was positioning Sylogist, if executed effectively, for future growth. The company continued to build cash and transitioned back to significant EBITDA growth in the fourth quarter as the impact of the reduced licensing rates with Microsoft became stronger. Subsequent to year-end, management completed the acquisition of the assets of K12 Enterprise and Sunpac Systems (detailed in our previous update). These companies provide enterprise resource planning solutions to kindergarten to grade 12 education authorities in the United States. The U.S. education market is a large addressable market, saddled with older technology requiring modernization. Armed with the K12 Enterprise software, which is a modern SaaS solution based on Sylogists Navigator ERP with Microsoft Dynamics at its core, the company continues to earnestly seek growth opportunities in that market. Management has stated they are encouraged with the potential growth prospects ahead.

**Valuation:** Applying a below market equivalent multiple of 15 times, the mid-range of management's 2018 expected adjusted EBITDA, would produce a fair value in the range of \$13.50 (comprised of 15 x \$0.825 + \$1.15 in cash) or 35% higher than the current range. The stock also pays a \$0.08 quarterly dividend for a yield of 3.2%, which we see as sustainable.

**Action now:** We are maintaining our rating on Sylogist at Speculative Buy. The shares are relatively illiquid, and we recommend investors use limit orders in the \$9.50-\$10.15 range. Be patient and positions should be filled over the next month.

## **GORDON PAPE'S UPDATES**

**Wells Fargo & Company (NYSE: WFC)**

*Originally recommended on Jan. 27/13 (#21304) at \$35.14. Closed Friday at \$56.13. (All figures in U.S. dollars.)*

**Background:** Wells Fargo is a diversified financial services company with \$2 trillion in assets. Founded in 1852 and headquartered in San Francisco, Wells Fargo serves one in three households in the U.S., providing

services in banking, insurance, investments, mortgage, and consumer and commercial finance. It has more than 8,500 locations, 13,000 ATMs, the Internet, and mobile banking. The bank has offices in 42 countries and territories and employs approximately 263,000 people. Wells Fargo was ranked No. 25 on Fortune's 2017 rankings of America's largest corporations.

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**Gordon Pape's updates – continued from page 6...**

**Performance:** Wells Fargo shares tumbled more than 9% on Feb. 5 and it wasn't just due to the market correction. The Federal Reserve Board imposed a harsh penalty on the bank as a punishment for creating 3.5 million unauthorized accounts.

**Recent developments:** In her final act before leaving the Fed chair, Janet Yellen prohibited Wells Fargo from increasing its balance sheet until such time as it "makes sufficient improvement" in risk management and compliance. In effect, the Fed has said that the third largest bank in the U.S. cannot grow its business for the foreseeable future.

This is unprecedented. As The Wall Street Journal pointed out in an editorial on Feb. 7, Wells Fargo has already paid a total of \$327 million in fines and settlement costs in a class action suit. The actual cost to customers of the fraud was \$6.1 million, all of which has been repaid. The company's CEO and chairman of the board have resigned, and several senior executives have been fired. In the light of all this, the Fed's ban on growth looks like overkill.

The company immediately responded by saying it takes the order seriously and will move quickly to comply. It has undertaken to provide plans to the Federal Reserve within 60 days.

"We take this order seriously and are focused on addressing all of the Federal Reserve's concerns," said CEO Timothy J. Sloan. "It is important to note that the consent order is not related to any new matters, but to prior issues where we have already made significant

progress. We appreciate the Federal Reserve's acknowledgment of our actions to date. In addition, the order is not related to Wells Fargo's financial condition -- we remain in a strong financial position and stand ready to serve the varied financial needs of our customers."

"Our board is committed to meeting the expectations of our regulators and protecting and serving the interests of our shareholders, customers, team members and the community," said Betsy Duke, independent chair of Wells Fargo's Board of Directors and a former member of the Board of Governors of the Federal Reserve. "Every change we've made over the past year reflects this and the valuable feedback of investors and stakeholders. Moving forward, we'll continue to be focused on maintaining an appropriate mix of professional experiences and diverse perspectives necessary to govern a franchise as important as Wells Fargo."

These statements are what you might expect from a company that, through its own mismanagement, has placed itself in a very difficult position. But the fact remains that the restriction on growth comes at the worst possible time, when rising interest rates are increasing the net interest margin of the banks, adding to their profitability and strengthening their balance sheets. Wells Fargo is going to miss out on this opportunity for at least several months and perhaps more.

**Action now:** Sell. We have several other U.S. banks on our list that are in a much better position to profit from the changing financial conditions. I originally recommended the shares at \$35.14 so we are exiting with a capital gain of almost 60%

## **RYAN IRVINE'S CROSS-COUNTRY SEMINARS**

Contributing editor Ryan Irvine and his partner Aaron Dunn of KeyStone Financial will be conducting a series of seminars next month titled Building a Winning Stock Portfolio Inside or Outside Your RRSP/TFSA – One Stock at a Time. The focus will be on providing investors with all the information needed to effectively structure a winning stock portfolio and, most importantly, to choose the right stocks to put in it.

"There is a powerful movement across the country – we see it every day as we add more new clients," Ryan says. "Canadians are taking charge of their financial future and looking for simple alternatives to help them build long-term wealth."

For the past 18-years KeyStone has been helping thousands of Canadians build simple 10-12 stock portfolios composed of cash generating and underfollowed stocks. The company stresses quality stocks over quantity in an

effort to beat the market long-term. In these investment seminar, Ryan and Aaron will share their strategies and offer a couple of recent stock selections to get you started on your path towards financial independence. Plus, you'll have an opportunity to ask questions on any topic covered in the seminar. It's a truly interactive session. Here are the dates and locations.

**Toronto:** March 1st @ 7pm - Sheraton Centre Toronto Hotel  
**Calgary:** March 6th @ 7pm - Sheraton Cavalier Calgary Hotel  
**Edmonton:** March 7th @ 7pm - Varscona Hotel on Whyte  
**Kelowna:** March 8th @ 7pm - Coast Capri Hotel  
**Victoria:** March 13th @ 7pm - Coast Victoria Hotel & Marina  
**Langley:** March 14th @ 7pm - Sandman Signatures Hotel  
**Vancouver:** March 15th @ 7pm - UBC Robson Square

Admission is \$29.95. Register soon, space is limited:  
<https://www.keystocks.com/events/diy-workshop.aspx>