Volume 23, Number 09 **Issue #21809** **February 26, 2018**

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B U I L D I N G W E A L T H

The Internet Wealth Builder

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Next issue:
March 5

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CORRECTION? WHAT CORRECTION?

By Gordon Pape, Editor and Publisher

We had an official stock market correction earlier this month. If you blinked, you may have missed it. The Dow dropped more than 1,000 points, not once but twice, on Feb. 2 and Feb. 8. By the time it hit its low on Feb. 9, it had fallen 2,826 points for the month, or 10.8%. That's officially correction territory.

Investors were spooked. Was this the start of another bear market? Was it 2008 all over again. Should we sell?

Now, less than three weeks later, it's as if it never happened. Stability has returned to the markets and the Dow was up 2.4% for the year as of the close on Friday. Both the S&P 500 and Nasdaq are also in positive territory for the year.

The TSX isn't doing as well, down 3.5% so far in 2017, but we have come to expect that these days.

So, what happened? Worries about rising interest rates and inflation were cited as the primary culprits. The plunge was exacerbated by margin calls that forced leveraged investors to liquidate part or all of their positions. The result was a week or so of turmoil, after which things settled down. However, the Dow is still in negative territory for the month and is off about 5% from its all-time closing high of 26,616.71, reached on Jan. 26.

What happens next?

"I've been waiting for a downturn like a cat sitting in front of a mouse-hole. Now what, please?" asked reader Emily C.

My advice is to use caution. The flash correction may be over but the underlying causes, concerns about rising rates and inflation, have not gone away. As well, stocks may be down from their highs but most still look expensive. With rates almost certain to rise at least twice more this year, expect increased pressure on stocks, especially interest-sensitive securities.

While our reader was watching that mouse-hole, presumably she thought about what to buy and set some entry levels. So, at this stage, watch those issues carefully. If any reach the target, start to gradually accumulate some shares. Don't buy the entire position at once. Rather, invest 25% to 50% of where you want to end up and see how the price performs after that. If it falls more, add some additional shares to your holdings. This is called layering-in and it's the best approach for markets such as this.

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BIG GAIN FOR GROWTH PORTFOLIO

Five and a half years ago, we created a growth-oriented portfolio for this newsletter. At the time, we knew that stocks were relatively cheap, but no one could predict the huge bull market run we have experienced since. As a result, this has become our most successful model portfolio, by a wide margin. It was originally set up by former contributing editor Tom Slee, and I took it over after he retired.

Although it has been the most successful, it is also the riskiest of all IWB portfolios, with 100% exposure to the stock market. However, thus far the risk has paid off very impressively. Just be aware that when the market hits its next bear phase, these numbers won't look so pretty.

The portfolio was valued at $10,000 when it was created, with the assets distributed among eight stocks. Three were U.S. companies while the rest were Canadian. We have switched several of the stocks over the years and now the mix consists of four Canadian and three U.S. securities.

Here are the securities that make up the current portfolio, with an update on how they have performed since our last review in August. Prices are as of the afternoon of Feb. 22.

Nvidia (NDQ: NVDA). We added this high-powered growth stock to the portfolio last August and it has paid off big time, with a six-month gain of almost 50%. It can't go on forever but enjoy the ride while it does. The stock also pays a small quarterly dividend of US$0.15 a share.

Alimentation Couche-Tard (TSX: ATD.B, OTC: ANCUF). This stock has been pretty well stuck in neutral for the past year after a long period of rapid growth. The shares are up only $1.38 since the last review and the dividend is a miserly $0.09 per quarter. We'll maintain our position for another six months but it we don't see a renewed growth spurt it may be time to move on.

WSP Global Inc. (TSX: WSP, OTC: WSPOF). WSP Global (which is reviewed in depth elsewhere in this issue) continues to do well. The shares gained $9.01 in the latest six-month period and we received two dividends totaling $0.75 per share.

Shopify (TSX, NYSE: SHOP). We advised selling Shopify in October after it was attacked by short sellers, but we did not dump it out of the portfolio at that time. That was fortunate as the shares have since rebounded strongly and are up more than $50 since the August review. This is an impressive vote of confidence by the market and we will restore Shopify to our Buy list.

New Flyer Industries (TSX: NFI, OTC: NFYEF). This Winnipeg-based manufacturer of public transit buses has been one of our best performers. The share price is up $4.82 since the last review. We also received two dividends of $0.325 each. This remains the number one performer in the portfolio with a gain since inception of 660%.

Apple Inc. (NDQ: AAPL). This company is the largest in the U.S. by market capitalization and the shares continue to gain ground. Since our last review, they have gone up by US$14.14 each. We received two dividends of US$0.63 each.

UnitedHealth Group (NYSE: UNH). This U.S. health insurance provider has pulled back from its high of late January, but the shares are still up almost US$35 since our last review in August. We received two quarterly dividends of US$0.75.

Cash. We received interest of $9.32 on our cash holdings in EQ Bank.

Here is how the portfolio stood on the afternoon of Feb. 22.

IWB Growth Portfolio (a/o Feb. 22/18)

Symbol	Weight %	Total Shares	Average Price	Book Value	Current Price	Market Value	Dividends Retained	Gain/ Loss %
NVDA	17.0	26	$161.47	$4,198.22	$241.62	$6,282.12	$11.44	+44.9
ATD.B	11.8	70	$16.63	$1,164.10	$62.52	$4,376.40	$81.01	+282.9
WSP	13.6	85	$21.94	$1,988.49	$59.07	$5,020.95	$152.98	+160.2
SHOP	17.1	37	$78.71	$2,912.27	$171.15	$6,332.55	0	+117.4
NFI	15.4	100	$7.95	$795.00	$57.26	$5,726.00	$322.13	+660.8
AAPL	9.3	20	$121.70	$2,434.07	$172.33	$3,446.60	$116.84	+46.4
UNH	15.4	25	$92.19	$2,304.86	$227.56	$5,687.00	$183.49	+154.7
Cash	0.4			$157.76		$167.08		
Total	100.0			$15,954.77		$37,038.70	$867.89	+137.6
Inception				$10,000.00				+279.1

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Growth portfolio – continued from page 2…

Commissions are not taken into account. The U.S. and Canadian dollars are treated as being at par but obviously gains (or losses) on the American securities are increased due to the significant exchange rate differential.

Comments: This doesn't happen very often. Every stock in this portfolio gained ground in the latest six months, with four of them adding more than $14 a share during the period. That produced an impressive gain of 21.5% for the overall portfolio.

The total gain over five and a half years is now 279.1% for an average annual compound rate of return of 27.42%. That is an excellent result, but I caution again that it won't go on forever. At some point the market will turn down and we will experience a setback in our results. Over time a 12% annual return is about right for this portfolio.

Changes: None. Why mess with success?

Our cash balance is now $1,034.93, which will stay in the EQ Bank account, which pays 2.3%.

I will revisit the portfolio in August.

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HOW "ANCHORING" WEIGHS DOWN RETURNS

By Shawn Allen, Contributing Editor

"Anchoring", when it comes to investing refers to becoming fixated on some particular data point, fact, or theory to the point that it clouds our judgement. For example, anchoring occurs when we fixate on the particular price that we paid for a stock or a previous higher price. Anchoring can also involve fixating too strongly on a theory, such as that because "X" has happened "Y" is sure to follow – and refusing to let go of the theory even when "Y" doesn't happen.

The following are some examples:

Fixating on a previous high: Many investors made a very serious "anchoring" mistake in the early years of this decade by fixating on a previous high point in the markets.

With the always crystal-clear vision of hindsight we now know that the S&P 500 index reached a major peak when it closed at 1527 on March 24, 2000. But it then crashed in the "tech-wreck", plunging 49% to a major low close of 777 on Oct. 7, 2002. Its next major high close was reached on Oct. 9, 2007 at 1565. It then plummeted in the financial crisis, reaching a major low on March 9, 2009 at 677. That was 57% below the 2007 peak and, what's worse, 56% below the year 2000 peak!

Since then, the S&P 500 has risen in an almost uninterrupted fashion. But it was not until the Summer of 2012 that the index once again surpassed that old 2000 peak (almost certainly) once and for all. Today, the S&P 500, at 2747, remains relatively close to its all-time high and has left those old peaks far back in the dust.

For several years starting in 2010 it became extremely common to hear investors and analysts complain that "no one has made any money in ten years" or "no one has made any money since 2000". These investors and analysts became illogically and excessively anchored on what was something of a "needle" peak back in 2000. It was as if they thought that most investors had placed their entire portfolio in the market on that day and nothing since and that the old peak should become the only reference point for all future performance. These investors were correctly observing the old peak and the decade of poor market performance. But they were completely wrong in understanding the future implications of that past data.

Those investors who, after 2009, remained anchored on that old year 2000 peak and who, as a result, became convinced that stock markets provide poor returns deprived themselves of stellar gains over the next nine (and, hopefully, counting) years.

Ascribing false reasons to market movements: Many investors who were "burned" by the financial crisis began to believe that markets were "rigged" and manipulated. As the market recovered strongly in 2009 some people, probably quite correctly, credited the Federal Reserve and quantitative easing for the stock market recovery. But many of them went on to continue to view the massive rise in stocks since that time as "fake" and fueled by debt. Whenever markets faltered but then recovered, these investors gave all credit to the, probably mythical, "plunge-protection-team". And when earnings per share rose, these fearful investors claimed that was largely fake as well, driven by share buy backs and debt.

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Anchoring – continued from page 3…

There was certainly much truth to the fact that the Federal Reserve's ultra-low interest rate policies and the resulting increased debt in the economy did support the stock market. But it now seems clear that those investors who became fixated and anchored on those factors and dismissed the very real growth in the economy and earnings continued to deprive themselves of stock market returns.

Refusing to look again at a stock because it is too late: I have a strong memory that Magna's stock dipped precipitously to about the $3 level in the early 1990s. I did not buy the stock. And even if I had it would not have been many shares because I had very little money available for investing at that time. Not long afterwards it started to charge higher and I believe it reached $100 within about ten years. For whatever reason, the fact that Magna had once fallen from a higher price down to about $3 really stuck in my mind. It may have been because it was one of the first stocks I ever recall "watching", and it likely had to do with the spectacular rise in the stock price soon after.

Whenever I thought about Magna for years afterword I would "anchor" on that old $3 price or on my failure to have bought at some price far lower than the subsequent highs. I believe that "anchoring" caused me to develop a strong mental block against Magna. There was no way I was going to buy the stock at, say, $20 after having failed to buy at $3. Nor at $40 having to failed to buy at $20. Subsequently, I have never analyzed the company or read a single one of its financial reports. I can tell myself that this was because there are simply too many companies to look at them all. But the reality is that my illogical anchoring on an irrelevant stock price from the early '90s is part of the reason.

Refusing to sell at a loss or even at a decline: A very common manifestation of anchoring is a strong aversion to selling anything at a loss or even at any price lower than a recent high. The stocks of quality companies do tend to rise over time for many reasons including through the growth associated with the retention of earnings. Therefore, for most companies (and certainly for most of those covered in IWB) we *will* get a chance to sell at a profit or at that previous high, so this sort of anchoring is certainly not always detrimental, much less fatal.

However, such thinking can be very detrimental in the case where something fundamental has changed and a stock is destined to decline and not recover. Consider Valeant (never an IWB pick), which hit highs over $335 in the summer of 2015. It turns out that this was a stock that simply never deserved to be that high. A short seller's negative report became the catalyst for an epic decline that ultimately bottomed under $12 in the Spring of 2017.

The short seller's report, however, was not the real reason for the decline. The balance sheet was extremely weak, management had presented a greatly inflated and dubious view of adjusted earnings, and the stock was vastly over-valued.

I wonder how many holders of Valeant became anchored on those highs above $300? As the stock fell below $300, I suspect that there were many who planned to sell as soon as it got back above $300. And then, as it fell below $200 I am sure there were many investors who, having refused to sell at $300 or $290 or $250 could not bring themselves to sell at $200 even as the bad news about this company mounted.

Thinking about former higher prices, which is a form of anchoring, makes it difficult for many investors to sell at lower prices. More common and less damaging versions of anchoring occur every day as investors hesitate to sell a stock today at $40 that was at $42 yesterday or last week. Or they hesitate to buy today at $42 having missed the opportunity to buy yesterday at $40. Past prices are irrelevant in theory, at least for value investors, but they always weigh on our minds.

How to battle anchoring: Anchoring can often be overcome by forcing yourself to take a fresh new look at the evidence. Rather than focusing simply on the stock price, this usually involves looking at the underlying earnings and growth in relation to the stock price. For example, my understanding is that Apple, which now trades at around $172, was trading at around only thirteen times earnings several years ago when it was around $65. Many analysts argued that it was therefore a bargain. It appears they were quite correct.

Anyone who refused to buy Apple at $65 because they were "anchored" on the fact that it had relatively recently traded at far lower prices of (if you can believe it) about $13 (split-adjusted) in early 2009 was making a mistake.

Anchoring, in the absence of updated analysis, can cause us to believe that a stock has run up too fast. Or it can make us refuse to consider a stock at a far higher price today because we simply don't want to be reminded that we missed the chance to buy at far lower prices in the past.

As humans, we will never be free of the emotional baggage of anchoring. But, by taking a fresh look at the evidence, including through reports such as we provide at IWB, we can often prevent it from weighing us down.

Contributing editor Shawn Allen 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.

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SHAWN ALLEN PICKS BHP BILLITON

This week, I am adding BHP Billiton to our list of international stocks. This is for those seeking international diversification.

Historically, I have almost completely avoided analyzing commodity companies of any kind. This is largely because the value ratio and company-specific methods that I use are not well suited to commodity companies. In addition, I believe that commodity companies often produce poor returns. Nevertheless, it might be a form of anchoring for me to completely swear off such a large segment of the market. I chose to take a look at BHP Billiton because its large size and diversification somewhat protects it from the swings in commodity prices.

BHP Billiton plc (NYSE: BBL)

Background: BHP Billiton is a huge Australia-headquartered global mining and petroleum exploration and extraction company. It has about 10 production locations in Australia, 10 in the Americas, as well as one in the United Kingdom and one in northern Africa.

The company has over 60,000 employees and contractors. Assets by commodity are 31% copper-related, 30% petroleum related, 25% iron ore-related, and 13% coal-related. But note that revenues were 39% iron ore, 22% copper, 20% coal, and 18% petroleum. The break-out by EBITDA was relatively similar to revenue although with iron ore even higher at 44%. Sales into China represented 49% of revenue in fiscal 2017 and Asia in total represented 77% of revenue.

Share structure: The share structure is unfortunately quite complicated in that BHP legally consists of two separate companies: BHP Billiton Limited, which trades as BHP in Australia and New York, and BHP Billiton plc, which trades as BLT in London and BBL in New York.

Despite being legally separate, the two are operated as one combined company and the shares in the two companies are said to be economically equivalent. Yet, for reasons that are not clear, the plc shares trade at a discount of about 10%. To further confuse matters, the shares that trade in New York are America Depository Receipts. BHP on New York represents two BHP Billiton Limited shares and BBL represents two BHP Billiton plc shares. Since the Limited and plc shares are said to be economically equivalent, my recommendation for North America investors is to buy BBL in New York and hope that the discount is reduced or eliminated at some point, which would provide an added boost to returns.

Currency risk: Canadian investors in this international company clearly face currency risk. However, that can also be looked at as a benefit due to the diversification. The specific currency risk here would be difficult to quantify. The company reports in U.S. currency and most of its commodities are likely sold in U.S. dollars. But fluctuations in the Australian currency would clearly affect results and there are likely small impacts from currency fluctuations in other countries where it operates as well. Note that buying the shares in Australia or London rather than New York would have essentially no impact on the currency risk – unless you are going to measure the investment in British pounds or Australian dollars.

Stock performance: As might be expected, the stock has a volatile history. It fell close to 80% from its 2011 peak to a bottom in 2015 and has recovered only about a third of the lost ground since then. Clearly this can be a dangerous stock to buy at peak times. But we should be cautious of anchoring our thinking on that past decline since the stock has risen considerably over the longer term in addition to paying its dividend.

Recent developments: The company reported first-half fiscal 2018 earnings on Feb. 20. GAAP earnings were down 37% but this was predominantly due to one-time charges related to U.S. corporate tax reform. Underlying adjusted earnings per share were up 25%. An activist investor has pushed for the "dual" shares to be consolidated in order to eliminate the discount on the plc shares. However, the company has rejected that suggestion.

Dividend: The company pays a dividend twice yearly. With the recently announced pay-out, the annual amount is $1.96 for each of the American Depository Receipts. That amounts to a yield of 4.2% on BHP and 4.7% on BBL. However, unlike almost all North American companies BHP tends to adjust its dividend down or up with earnings. For this and for reasons related to taxation, this is a stock that should be bought for potential capital appreciation and not for the dividend.

Balance sheet: This company has a strong balance sheet with relatively modest debt relative to its assets and cash flows. Its assets consist largely of plant and equipment. Only 3% of its assets represent purchased goodwill.

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BHP Billiton – continued from page 5…

Value ratios: Analyzed based on the recent price of US$41.74 per share for the BBL American Depository Receipt. The price to book value ratio does not seem unreasonably high at 2.1 considering that much of the assets may have been developed many years ago and that depreciation and depletion charges may (or may not) have been offset by inflation. The dividend yield is attractive at 4.7%. The p/e ratio is somewhat attractive at 14.8. The ROE is reasonably good at 12% for fiscal 2017 and is improving in fiscal 2018. Given the commodity nature of this company, its earnings are inherently volatile and unpredictable. Therefore, the value ratios can change unusually quickly. At the current earnings, the value ratios support a rating of Buy.

Outlook: Earnings in the short term are unpredictable since these are heavily dependent on volume of production and demand (which seems likely to grow) and, even more so, on commodity prices (which we cannot predict). BHP traces its history back 130 years and has a strong balance sheet and is certainly likely to remain in business for the indefinite future. It seems likely that it can continue to grow in the long term.

Risks: Wide swings in commodity prices are a big risk. There are many operational risks as well, some of which can lead not only to production reductions and loss of investment but also to large external legal liabilities. The annual report lists many risks.

Action now: This is a Buy for investors seeking exposure to a diversified global non-precious-metals mining company. Investors should expect the stock performance to depend on world economic growth and on commodity prices. While the stock trades in two different classes and three currencies, for tracking purposes we will use BBL which is the American Depository Receipt for BHP Billiton plc. It closed Friday in New York at US$42.75.

SHAWN ALLEN'S UPDATES

Canadian Tire Corporation Ltd (TSX: CTC.A, OTC: CDNAF)

Originally recommended by Tom Slee on June 13/11 (#21121) at C$61.58, US$62.90. Closed Friday at C$176.15, US$139.38.

Background: Canadian Tire is a family of businesses that includes a retail segment, a financial services division, and CT REIT. The retail business was founded in 1922 and includes PartSource, Gas+, Mark's, and FGL Sports. The company has approximately 1,700 retail and gasoline outlets.

Performance: The stock was up 18% in 2017 and is up a further 8% in 2018 to date. Since it was originally recommended, the shares have gained 186%.

Recent developments: The company announced that for 2018 the dividend will increase by a hefty 38% as the earnings payout target ratio was raised to 30% to 40%. In the fourth quarter, revenues per share were up 15.5% and earnings per share were up 19.7%. This performance continued the strong results that the company has exhibited in recent years. The company has also been aggressive in buying back shares, which has been an added boost to earnings per share.

Valuation: Analyzed at Wednesday's closing price of $177.61. The price to book value ratio seems reasonable to moderately high at 2.5. The dividend yield is modest at 2%, reflecting the still relatively low payout ratio of 33% of earnings. The ROE is quite attractive at 15.2%. Earnings growth per share over the past five calendar years has been quite strong at a compounded average of 10.6% per year. Sales per share growth was reasonably good at a compounded average of 6.9% in the past five years. The trailing 12 months p/e is reasonable at 16.6.

Risks and outlook: Canadian Tire appears set for continued growth over the years. There is, however, some risk of more intense competition particularly from online retailers.

Dividend: The dividend was increased by 38% effective with the March 2018 payment to $0.90 per quarter ($3.60 annually).

Action now: The recent strong share price performance is supported by earnings growth and Canadian Tire remains a Buy.

WSP Global (TSX: WSP, OTC: WSPOF)

Originally recommended by Tom Slee on July 8/12 (#21224) at C$22.40, US$22.18. Closed Friday at C$59.15, US$46.71.

Background: WSP Global Inc. provides engineering and related professional consulting services through 500 offices in 40 countries. WSP is very much a growth-by-acquisition company. The employee count has grown from 1,600 in 2006 to 36,000 in 2017. The share count increased from 11 million in 2006 to 102 million in 2017.

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Shawn Allen's updates – continued from page 6…

While headquartered and trading in Toronto and reporting in Canadian currency, this is truly a global business. Revenues are sourced as follows: 37% from Europe, the Middle East, India and Africa; 30% from the U.S. and Latin America; 19% from Canada; and 14% from Asia and Australia. Project categories are: 49% Transportation and Infrastructure, 31% Property and Buildings, 11% Industry and Energy, and 9% Environment.

The company went public as an income trust in 2006 under the name Genivar. It then completed over 60 acquisitions by 2012. It changed to a corporation structure at the start of 2011. The Genivar name had been adopted in 1993, tracing its roots to two Quebec City firms that started in 1959 and that had merged in 1987. It acquired three Montreal firms in 1993. Over 30 acquisitions were made by the time it went public.

In 2012 the company purchased WSP Group PLC based in London, which had 9,000 employees and operated in 30 countries. WSP (formerly William Sale Partnership) had traded in London since 1987 and had been founded in 1969, but some of its acquisitions traced their history back to 1885 in New York and 1887 in the U.K. Genivar paid $438 million for the shares of WSP. For comparison, Genivar had $501 million in equity at the end of 2011 and 5,000 employees. Subsequently it made many more acquisitions. The company reorganized under the name WSP Global Inc. in 2014.

Performance: The stock was up 34% in 2017 and is relatively unchanged so far in 2018. It is up about 164% since the original recommendation in 2012.

Management quality: I would judge the quality of management to be excellent given the achievement of massive growth-by-acquisition accompanied by strong growth on a per share basis and a stock price that rose from an issue price of $10 in 2006 to a recent $60 while also paying out half or more of the earnings as dividends. It was the tremendous drive and ambition of management that led to the massive and rapid growth.

Risks: Risks include the challenges of managing and coordinating a global company with 500 offices. There are risks associated with cost over-runs on fixed-price (or fixed hours) bids. There could be uninsured liabilities associated with projects.

Valuation: Analyzed at Wednesday's closing price of $58.63. The price to book value ratio is ostensibly reasonable at 2.1 but note that the great majority of its operations were acquired in acquisitions in relatively recent years. Those acquisitions were at premiums to book value of the acquired companies. Therefore, the price to book value here is relatively meaningless but does suggest that we are paying slightly more than double what the company itself paid relatively recently, which could be considered a steep premium.

The dividend yield is relatively modest at 2.6%. The p/e ratio at 19.4 appears somewhat unattractively high in isolation. The return on equity is acceptable at 10.75%. Earnings per share growth in the past five years has been strong at 10%. Intrinsic value is calculated at $63 if we assume 8% annual earnings per share growth for five years followed by a sale at a market average p/e of 17. But it would be $87 if we assume 12% annual growth (which may be rather optimistic) and the p/e stays at about 19. Overall these value ratios are not all that compelling but likely justify a rating of Buy.

Action now: Existing owners should continue to Hold. New investors should consider taking a half position at this time.

MEMBERS' CORNER

Building a portfolio

Member comment: if i were to set up one of your model portfolios today, how should I proceed? Do I see what the portfolio has and then buy these securities today in the same ratio that exists currently? I'm a little confused so please explain. – John

Response: I suggest you build the portfolio over a period of time, using the current percentages as your guide. So, for example, you might buy one quarter of your position now and another quarter in a couple of months. Do it in four tranches and then follow the recommendations made at each review period. - G.P.

Last call for Ryan Irvine's seminars

Just a reminder the contributing editor Ryan Irvine and his KeyStone associate Aaron Dunn will be conducting a series of valuable investment seminars next month. Admission is only $29.95.

For full details including dates and locations go to https://www.keystocks.com/events/diy-workshop.aspx

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