The Internet Wealth Builder

Volume 23, Number 19 **Issue #21819** **May 14, 2018**

I N T H I S I S S U E

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

The Internet Wealth Builder

Editor and Publisher: Gordon Pape

Associate Publisher: Richard N. Croft

Website: www.buildingwealth.ca

No IWB next week:
Next issue May 28

Customer Service:
1-888-287-8229

RIGHTING A LISTING SHIP

By Gordon Pape, Editor and Publisher

You have to give credit to Enbridge's management team. They're doing all they can to right this listing ship.

It appears they are making some progress. The share price has bounced back from its five-year low of $37.36 in late April, closing in Toronto on Friday at $43.14. But the recovery may not be happening fast enough to satisfy disgruntled investors. They have been getting twitchier as they watched the stock lose more than a third of its value in the year to April 25, when it reached its nadir.

Enbridge used to be one of the most dependable stocks on the TSX. From the late 1990s to early 2015, the chart shows a steady upward progression and regular dividend increases. The drop in oil prices temporarily knocked the price back but it recovered and was moving up again until just before the deal to acquire Spectra Energy, based in Houston, closed in February 2017.

So why did investors turn sour?

In a recent report titled "Hey Enbridge, What's Wrong?" analyst Michael O'Callaghan of CIBC Private Wealth Management said that part of the reason for the initial drop in Enbridge shares after it completed the Spectra purchase can be traced to index investing. Spectra was part of several major U.S. stock indices. After the deal closed, U.S. index investors sold the Enbridge shares they received and bought the company that replaced Spectra on those indices. That put immediate downward pressure on the stock.

That was just the start of the company's problems. Concern grew over Enbridge's $65 billion debt load at a time when interest rates are on the rise. When Moody's downgraded $20 billion of that debt in December, it was a signal that the worriers were right.

Doubts also began to arise over Enbridge's promise to increase its dividend by 10-12% a year over the next seven years. Sure enough, in November the company reduced its target to 10% a year over four years. The naysayers were proven right again. There is even talk of a possible dividend cut to fund future capital expenditures.

Continued on page 2…

Listing Ship – continued from page 1…

All this was happening as rising rates were putting downward pressure on all interest-sensitive stocks.

So what is the company doing about it? For starters, it announced in November it will sell off some assets to raise cash and reduce debt. The goal, the company said, is “to focus on a pure regulated pipeline and utility business model over time, emphasizing low risk and strong growth in three core businesses: liquids pipelines and terminals, natural gas transmission and storage and natural gas utilities”.

To that end, Enbridge announced last week that it has reached a deal with ArcLight Capital Partners to sell Midcoast Operating, L.P. and its subsidiaries for $1.4 billion. Midcoast handles the company’s U.S. natural gas and natural gas liquids gathering, processing, transportation, and marketing businesses, serving established basins in Texas, Oklahoma, and Louisiana. The transaction is expected to close in the third quarter of this year.

In another deal, the Canada Pension Plan Investment Board (CPPIB) will acquire a 49% interest in all of Enbridge's Canadian renewable energy generation assets plus 49% of two large U.S. renewable assets. Also, part of the transaction is 49% of Enbridge’s interest in the Hohe See wind farm in Germany. The sale is worth $1.75 billion. In addition, CPPIB will fund its pro-rata share of the costs to further develop the German project. This will reduce Enbridge's future funding requirement by roughly $500 million.

Enbridge also announced a further joint venture with CPPIB to co-invest in any future European offshore renewable projects. The company says this partnership “will provide a reliable source of alternative capital for the future development of this platform”.

Although Enbridge has surpassed its target of $3 billion in asset sales this year, the company may not be finished. CEO Al Monaco confirmed it is studying offers for some of its other non-core assets, particularly its Canadian mid-stream properties. He said on Thursday several companies have expressed “very, very strong interest” in making bids.

Enbridge’s first-quarter results, released on May 10, also pleased investors and beat analysts’ estimates. The company announced adjusted earnings of almost $1.4 billion ($0.82 per share) compared to $675 million ($0.57 per share) in the first quarter of 2017.

"Our strong financial results for the first quarter of 2018 clearly demonstrate the quality of the assets, predictability of cash flows, and the accretive nature of the Spectra Energy merger,” said Mr. Monaco. “We're now benefiting from the significant financial synergies that we have captured to date from the deal and other efficiency efforts, and, as expected, we are seeing reliable and growing cash flow and earnings from the $12 billion in new capital projects that we brought into service through 2017.”

In his analysis, which was written before the financial results came out, Mr. O’Callaghan of CIBC noted that while the company still has problems, there are some bright spots to focus on. At the top of the list is yield. Enbridge raised its dividend in February by 10% to $0.671 per quarter ($2.684 per year). At Friday’s closing price in Toronto of $43.14, the stock yields 6.2%. He pointed out that if the company maintains its policy of 10% annual dividend hikes, the yield on shares bought now would increase to the 8% range by the end of 2020.

He noted that the drop in share price means Enbridge is trading at a low valuation compared to historic levels. He also commented that with about $22 billion in new projects to be brought on line by the end of 2020, cash flow should increase. Distributable cash flow in the first quarter was $2.3 billion, up from $1.2 billion the year before. Cash provided by operating activities was $3.2 billion compared to $1.8 billion last year.

Analyst Robert Kwan and associate Tim Tong of RBC Capital markets were also positive about the stock, rating it as “outperform” with a target of $54. However, they dropped their target from $59, citing “compression in valuation multiples” for comparable companies.

Enbridge still has some problems to overcome but based on the latest news the April 25 low may have been the bottom of this cycle. Income oriented investors may wish to consider buying shares at this point to take advantage of the attractive yield.

However, if your focus is on capital gains there are other stocks in the energy sector that have greater potential, especially now with the price of oil on the rise after the U.S. pullout from the Iran nuclear deal.

Follow Gordon Pape on Twitter @GPUpdates and on Facebook at www.facebook.com/GordonPapeMoney

VOLATILITY INDEXES REFLECT YOUR EMOTIONS

By Richard Croft, Associate Publisher

A few years back the TMX developed a Volatility Index (symbol VIXC) that tracked the level of option premiums on the iShares S&P/TSX 60 Index Fund (TSX: XIU). The XIU is an index that reflects the performance of 60 large Canadian companies in a cross section of industries.

The idea behind VIXC is to provide investors with a view as to how volatile participants believe the stock market will be over the next month.

VIXC is built on the same principals used by the Chicago Board Options Exchange Volatility Index (symbol VIX), which measures the volatility of the S&P 500 Composite Index. In short, VIXC measure risk in the Canadian stock market while VIX measures risk in the U.S. market.

A rising volatility index value reflects heightened fears among investors over the near term, generally thought to be looking forward for one month. Volatility indexes tell us if options are relatively cheap or expensive at a point in time. Higher volatility translates into more expensive options, which makes selling them more attractive. Lower volatility indicates smaller premiums, which could make long option strategies more attractive.

Volatility indexes measure the volatility being implied by the near month at-the-money index calls and puts. Usually these options are the most actively trade and, by extension, tend to look and act most like an average option contract.

These indexes are typically used to gauge the mood of investors in terms of their willingness to enter risk-on trades. In that sense volatility indexes are considered sentiment indexes with a contrarian bent.

The contrarian angle comes from nearly 40 years of documented historical performance for VIX, which typically spikes at major market bottoms. A spike in the VIX is generally seen as a point where the index triples the value of its 200-day moving average. Over the past two years, the 200-day moving average for VIX is between 14 and 16, suggesting spikes would be in the 45 to 55 point range. This is something we have witnessed twice in the past three years (see accompanying chart), most recently in early March. Both instances marked a significant bottom in the stock market. Note the performance of the S&P 500 Index, which has been overlaid on the chart.

I'm often asked why volatility is, well, so volatile. Statistically, market volatility is six times more volatile than the S&P 500 Index itself, which is the historic norm. That's not surprising when you consider that volatility is measuring emotions, which at extremes represent fear and greed.

The VIX peaks when the market is bottoming, because it represents the point at which the last investor pays the highest price to purchase a put option to protect the value of his/her investment. It's much like trying to buy fire insurance when your house is already ablaze. Fear and greed are ingrained in our emotional psyche and having the ability to quantify that fact makes VIXC and VIX insightful tools to measure extremes in investor sentiment.

Take a look at the VIX chart, with the S&P overlay.

The VIXC index does not have the same historical perspective as the VIX as data is only available since December 2002. Still, VIXC has been an effective gauge of sentiment among Canadian investors.

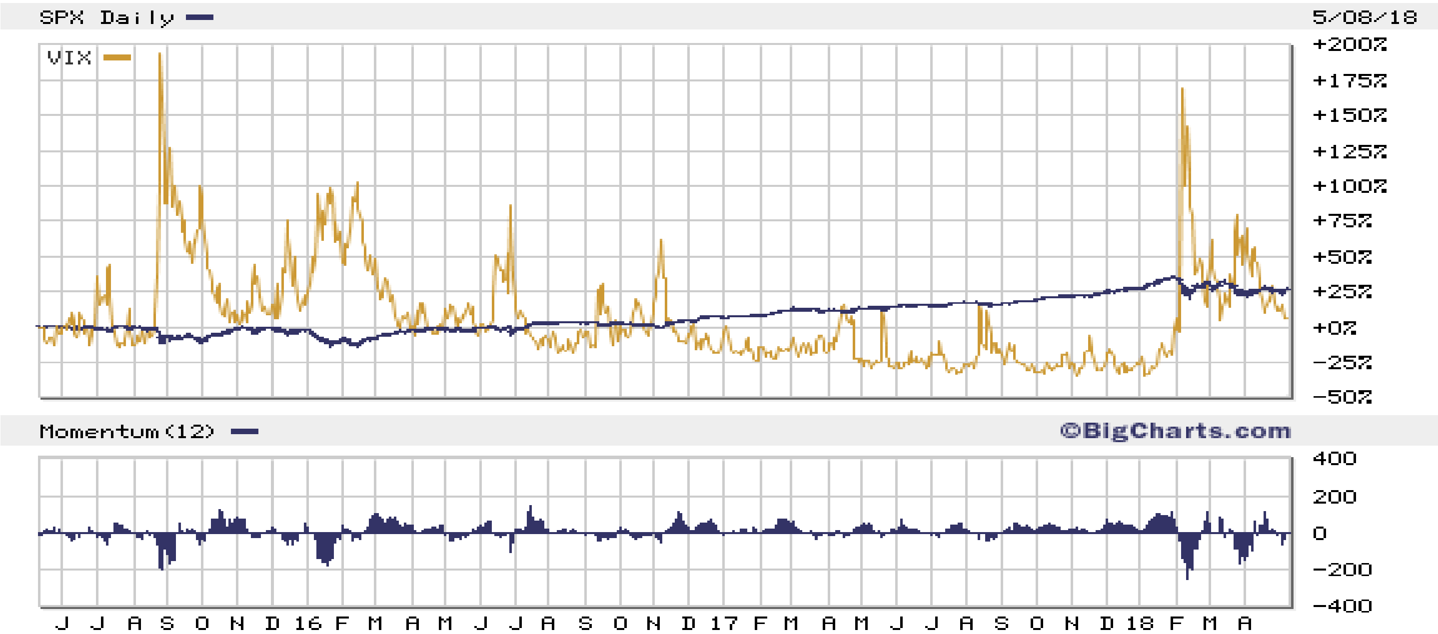
Interestingly, and perhaps not surprisingly, I would expect VIXC values to be less than what is typically recorded on the VIX. The VIXC typically trades in the 9 to 11 price point where VIX normalizes in the 12 to 14 range. Part of the gap between the U.S. and Canadian experience can be explained by the less robust intraday movements in Canada versus what is typically seen in the U.S. market.

Another factor relates to the weighting of XIU versus the S&P 500 composite index. While both are capitalization-weighted indexes, the XIU has a much higher weighting in natural resource companies, particularly companies in the oil and gas and precious metal sectors. These sectors tend to be counter cyclical (i.e. they move opposite of the trend of the general economy). Within the context of a portfolio index, heavier weightings in counter cyclical industry groups tend to smooth out the fluctuations in the overall index.

Beyond using the index as a sentiment indicator at market extremes, investors can use it as a sounding board to establish which option strategy makes the most sense given your directional bias for an underlying stock.

Continued on page 4…

Volatility – continued from page 3…



For example, let's assume that you are bullish on the short-term prospects for XYZ Corp. You have a couple of choices to take advantage of that view. You could simply buy short-term calls on XYZ or you could buy the underlying shares and sell a covered call.

The strategy of choice would depend on whether you felt option premiums were high or low. The VIXC and VIX data indicates where option premiums are in the current cycle. If option premiums are above the norm you may want to engage in a covered call strategy, whereas below trend premium levels may indicate a long call strategy.

This is not the only arrow in one's trading quiver, but for option traders it is a tool that should be considered before entering an option trade.

Currently, the VIX has come back from extreme levels, which makes covered call strategies less attractive. Still, there are sectors where such strategies look particularly interesting.

See the following story for more details.

TRUMP, IRAN, AND THE ENERGY SECTOR

By Richard Croft, Associate Publisher

We have seen some spikes in volatility related to oil prices given President Trump's decision to exit the Iran nuclear arms deal and to reinstate sanctions. In the early stages of this exit oil moved higher, then fell sharply, and at the time of writing had recovered slightly.

The thinking is that some Iranian oil (at this point, no one knows how much) will be removed from the supply lines, which could cause prices to rise. Adding to the concern is the fact that Venezuela (the country with the second largest reserves within OPEC) is falling into the abyss plus growing worries about supplies from Libya.

However, Saudi Arabia, which is relishing Iran being taken to the woodshed, has committed to ramping up supply to stabilize prices. I also suspect U.S. production will increase much faster than expected. And, lest we forget, the world is still awash in oil with much of it sitting on oil tankers anchored offshore at major ports.

Continued on page 5…

Trump, Iran – continued from page 4…

This recent activity in the oil market has pushed up option premiums on individual oil companies, particularly Suncor (TSX: SU) and Canadian Natural Resources (TSX: CNQ). Suncor is on the IWB Recommended List. CNQ is not but was selected as a covered write because it is a mid-size Canadian energy company with decent volatility metrics and liquidity for the options. It is not because I like the company better than others but for the intended strategy it has the best metrics and we hold a small CNQ position in our company's option writing pool.

With that in mind, I recommend buying Suncor at $50.92 per share (closing price on May 11) and selling Suncor September 52 calls for $1.46. As well, or alternatively, you can buy CNQ at $46.04 and sell the August 48 calls at $1.24.

Here are the return projections for these covered call strategies, based on 100 shares (excluding commissions and dividends).

Suncor

Cost of shares	$5,092.00
Premium received from call	$ 146.00
Net out of pocket cost	$4,946.00
Net cost per share	$ 49.46

If the option is exercised at $52, your return will be $2.54 per share (capital gain plus the option premium), or 5% in about four months. If the option is not exercised, you keep the stock with a profit of $1.46 per share (2.9%) and can write a new call and collect the premium.

Canadian Natural Resources

Cost of shares	$4,604.00
Premium received from call	$ 124.00
Net out of pocket cost	$4,480.00
Net cost per share	$ 44.80

Here, if the option is exercised at $48, your return will be $3.20 per share or 6.95% in about three months. Again, if the option is not exercised, you keep the stock with a profit of $1.24 per share (2.7%) and can write a new call.

RICHARD CROFT'S UPDATES

U.S. Concrete (NDQ: USCR)

Originally recommended on Jan. 17/17 (#21703) at $62.40. Closed Friday at $58.70. (All figures in U.S. dollars unless otherwise stated.)

Background: U.S. Concrete serves the construction industry in several major markets through its two business segments: ready-mixed concrete and aggregate products. The company has 181 standard ready-mixed concrete plants, 17 volumetric ready-mixed concrete facilities, and 19 producing aggregates facilities. During 2017, U.S. Concrete sold approximately nine million cubic yards of ready-mixed concrete and approximately 6.2 million tons of aggregates.

Performance: The stock hit a 52-week high of $86.35 in December but has been dropping since that time.

Recent developments: The company reported increased revenue in the first quarter but the bottom line ended with a loss, due in part to bad weather conditions that hampered construction in several parts of the country. Consolidated revenue was up 9.6% year-over-year to $327.8 million. However, the net result was a loss of $3.9 million ($0.23 per share) compared to a profit of $6.8 million ($0.44 per share) a year ago.

However, CEO William J. Sandbrook said the outlook for the rest of 2018 is positive. "We have grown and maintained record backlog levels, we have just scratched the surface on the production and earnings capacity of our recent acquisitions and demand remains high in all of our markets, which we intend to capitalize on in the coming months with the cooperation of more normalized weather," he said.

The company continues to grow and last fall completed the acquisition of Canadian firm Polaris Materials (a former IWB recommendation) for C$300.7 million. Mr. Sandbrook said the purchase "represents a key success in our vertical integration growth strategy. The addition means more than just an internal source of aggregates for our ready-mixed concrete business in Northern California and entrance into new markets, but represents our ability to provide high-quality materials in otherwise supply-constrained areas for the foreseeable future. Our integration of Polaris remains ahead of our internal plan, and we continue to aggressively work on the acceleration of volume into the various markets we serve as well as plans to further develop land acquired as part of the transaction for additional capacity. We are extremely excited and confident with the anticipated returns from this dynamic acquisition."

Continued on page 6…

Richard Croft's updates – continued from page 5…

Dividend: The stock does not pay a dividend.

Comment: U.S. Concrete was initially recommended as an infrastructure play, on the assumption that President Trump would be able to get Congress to approve a major infrastructure investment program. This has not yet happened but I expect it is coming.

I am also optimistic that business investment will pick up based on the revised corporate tax rules that allow companies to write down the cost of new projects within the first year. Finally, a reduction in the corporate tax rate should provide some real oomph to the bottom line of companies like USCR.

Action now: There is a lot to like about this investment but its performance since hitting the $86 mark has been disappointing. I would suggest readers Hold their position but put in a stop loss at $55 just in case there is continued selling pressure. I would look to sell at $70 per share if the stock rises when construction picks up over the summer. USCR also has options so you could consider selling August 65 calls at around $2.50 per share.

H&E Equipment Services (NDQ: HEES)

Originally recommended on Jan. 15/18 (#21803) at $40.82. Closed Friday at $38.06. (All figures in U.S. dollars.)

Background: H&E operates an integrated equipment services company, renting, selling, and servicing hi-lift or aerial work platform equipment, cranes, earthmoving equipment, and industrial lift trucks.

Performance: The stock moved up to a high of $44.24 a few weeks after my recommendation but has been in a downtrend since that time.

Recent developments: First-quarter results were quite good. The company reported that revenue increased 14.8% to $260.5 million versus $226.8 million in the same period a year ago. Net income was $9.5 million ($0.26 per share, fully diluted), up from $5.4 million ($0.15 per share) last year. One of the reasons for the improved bottom line was a drop in the tax rate from 36.8% to 27.5%, reflecting the corporate tax cuts passed by Congress last fall and signed into law by President Trump just before Christmas.

CEO John Engquist was positive about the results, saying: "We are excited about 2018 for our business and industry. Demand in the non-residential construction markets we serve is above year-ago levels and broad-based throughout our geographic footprint. In addition to solid general project activity, energy-related work in our Gulf Coast region is strong, benefitting both our rental and distribution businesses. With our recent acquisitions of CEC and Rental Inc., we have added eight branches thus far this year. Rapidly executing on our stated growth strategy is a high priority and we are continuing to explore additional acquisitions and market expansion through Greenfields and warm starts."

Dividend: The shares pay a quarterly dividend of $0.275 ($1.10 per year), to yield 2.9% at the current price.

Comments: Like USCR, this is an infrastructure play and will be impacted by many of the same factors. The shares were hit particularly hard during the market sell-off in February, bouncing off the $32 price point. The stock has recovered nicely, particularly over the past week.

There is a reasonable options market for HEES shares, so you could sell an August 40 call at $1.90 if you wanted some downside protection.

Action now: Hold. Sell covered calls if you wish to generate extra income.

iShares Russell 2000 ETF (NYSE: IWM)

Originally recommended on Jan. 15/18 (#21803) at $158.16. Closed Friday at $159.84. (All figures in U.S. dollars.)

Background: IWM is an exchange-traded fund that tracks the U.S. small cap market.

Performance: The units dropped sharply during the February market correction but have since recovered and are trading slightly higher than my original recommended price. To May 10, the fund was ahead 4.87% year-to-date.

Key metrics: This is a very large ETF, with almost $44 billion in assets. It represents almost the entire U.S. small cap universe, with 1,979 holdings. The p/e ratio of the portfolio is 21.14% and the annual distribution yield is 1.09%. The management expense ratio is a low 0.19%.

Comments: I recommended this ETF in January mainly because I felt that small-cap domestic companies would gain the most from the Trump tax cuts. These will provide some oomph to this sector in the third and fourth quarters and, if the U.S. economy remains strong, I think IWM will provide a better bang for the investment dollar than some of the broad-based indices like the S&P 500 or the Dow Jones Industrial Average. The ETF has recovered from the February swoon and in my mind is set to move to higher levels.

Action now: Hold.

GORDON PAPE'S UPDATES

Brookfield Asset Management (TSX: BAM.A, NYSE: BAM)

Originally recommended on April 6/97 (#9713) at C$4.09 (split-adjusted). Closed Friday at C$51.86, US$40.57.

Background: Brookfield Asset Management has more than 100 years of history of owning and operating assets with a focus on property, renewable energy, infrastructure, and private equity. Total global assets under management are worth $285 billion.

Performance: After reaching a 52-week high of $57.04 in December, the stock was hit hard in the February correction, dropping to the $48 range. It has recovered recently although it is still well below the December level.

Recent developments: The company reported strong first-quarter results, beating analysts' estimates. Funds from operations (FFO) increased significantly to $1.2 billion ($1.16 per share), up 74% from $674 million ($0.65 per share) in the prior year (note that Brookfield reports in U.S. dollars). This included $473 million of disposition gains from assets sold.

Net income was $1.86 billion ($0.84 per share) compared to $518 million in the same period of 2017.

"We reported record results and significantly advanced our business plan," said CEO Bruce Flatt. "Fundraising for our latest flagship real estate fund is well advanced and we recently launched fundraising for our next flagship private equity fund. Investment performance has been strong across our business, and we continue to monetize assets at attractive valuations."

The monetization process included the sale of the company's 28% interest in Transelec, a Chilean electricity transmission business with approximately 10,000 kilometers of lines. The company recognized a disposition gain of approximately $245 million in FFO on the sale.

Asset sales also included a 50% interest in the Bay Adelaide Centre West and East towers, located in downtown Toronto, for C$850 million.

Dividend: In February, Brookfield increased its quarterly dividend to $0.15 ($0.60 per year), to yield 1.5% at the current price.

Comments: Brookfield was one of the first stocks we recommended, back in 1997. On a split-adjusted basis the shares are up more than 1,100% since then. However, I continue to see good value in this company.

Action now: Buy. Take advantage of the recent pullback in the share price.

Telus Corp. (TSX: T, NYSE: TU)

Originally recommended on Nov. 13/06 (#2640) at C$27.43, US$24.26 (split-adjusted). Closed Friday at C$45.70, US$35.73.

Background: Telus claims to be Canada's fastest-growing telecommunications company, with $13.8 billion of annual revenue and 13.1 million subscriber connections. The company provides a wide range of communications products and services, including wireless, data, Internet protocol (IP), voice, television, entertainment and video, and is Canada's largest healthcare IT provider.

Performance: The stock hit an all-time high of $48.94 in late November. It then dropped to the $44 range in February but has since been edging higher.

Recent developments: The company reported first-quarter results that were in line with analysts' estimates. Operating revenue was up 6% year-over-year to just under $3.4 billion. Adjusted net income was ahead 4.1% to $435 million ($0.73 per share) compared to $418 million ($0.71 per share) the year before. Free cash flow was $443 million, a jump of more than 100% from $217 million in 2017.

The company announced good growth in new wireless subscribers, gaining 48,000. That beat estimates although it lagged behind gains reported by competitors BCE, Rogers, and Shaw Communications.

The RBC Capital Markets analysis team, headed by Drew McReynolds, issued a glowing report on the company, saying: "We believe Telus has entered an inflection period whereby key performance metrics, sentiment, competitive position, and NAV growth are set for multi-year improvement." RBC rates the stock as "outperform" with a target of $52.

Continued on page 8…

Gordon Pape's updates – continued from page 7…

Dividend: Telus pays a quarterly dividend of $0.505 ($2.02 per year) to yield 4.4% at the current price.

Action now: Buy.

Walmart (NYSE: WMT)

Originally recommended on June 24/12 (#21222) at $67.30. Closed Friday at $83.38. (All figures in U.S. dollars.)

Background: Walmart is the world's largest bricks and mortar retailer with 11,700 stores in 29 countries, plus e-commerce operations in a growing number of countries. It employs some 2.3 million people worldwide and had revenue in the 2018 fiscal year of more than $500 billion.

Performance: The stock shot up to almost $110 in late January but then went into a decline from which it has yet to recover.

Recent developments: Walmart has released results for its 2018 fiscal year (to Jan. 31). Total revenue was $500.3 billion, an increase of $14.5 billion, or 3%. Net income attributable to Walmart shareholders was $9.7 billion ($3.28 per share, fully diluted). That was down significantly from $13.6 billion ($4.38 per share) in fiscal 2017. The company cited a number of reasons for the profit decline including restructuring charges and debt repayment. Management said that fiscal 2019 should see a strong rebound, with earnings par share projected to come in between $4.75 and $5. However, these projections were made prior to the Flipkart deal, which is discussed below.

One encouraging note in the report was an increase of 44% in U.S. ecommerce sales. Walmart has been bulking up that side of its business with the aim of competing more vigorously against Amazon.

Acquisition: Last week Walmart announced it is paying $16 billion to buy a 77% stake in Flipkart, the largest ecommerce company in India. Closing is expected later this year, subject to regulatory approval.

"Flipkart has established itself as a prominent player with a strong, entrepreneurial leadership team that is a good cultural fit with Walmart," said Judith McKenna, CEO of Walmart International. "This investment aligns with our strategy and our goal is to contribute to India's success story, as we grow our business. Over the last 10 years, Flipkart has become a market leader by focusing on customer service, technology, supply chain, and a broad assortment of products. With Flipkart and the other shareholders who have come together, we will continue to advance the winning ecommerce ecosystem in India."

However, the deal will not be immediately accretive to Walmart. In fact, the company is looking to take a hit of around $0.25 to $0.30 a share this year if the deal closes before the end of the second quarter and $0.60 a share in fiscal 2020.

Investors were not impressed. The share price dropped $2.68 on the day the announcement was made, although it rebounded a little on Friday.

Dividend: The stock is paying a quarterly dividend of $0.52 a share ($2.08 per year) to yield 2.5% at the current price.

Action now: Hold. The Flipkart deal may turn out to be highly advantageous in the long term as it gives Walmart a strong ecommerce position in one of the world's fastest-growing markets. But in the short run, it presents headwinds to earnings growth.

MEMBERS' CORNER

Tax software

Member comment: I appreciate your feedback on UFile and TurboTax. I tried something new this year: Simple Tax. Overall, it was a pleasant process. Best of all, I had the opportunity to save a full pdf of my T1 General. Payment is at the end, on a donation basis. I have no affiliation with this or any other tax software company. – Joy M.

That's it for today. Please note the IWB will not be published next week to allow our staff to enjoy the holiday weekend (we publish 44 times a year).

We will be back on May 28.

Have a happy and safe holiday!