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NASDAQ POWERS HIGHER

By Gordon Pape, Editor and Publisher

And the beat goes on! Nasdaq set another all-time record last week, closing on Wednesday at 7,689.24. We're in rarefied territory here; the composite is trading well above its 50- and 200-day moving averages and there seems to be no end in sight.

Record highs always make me nervous because markets don't go straight up forever. Sooner or later they crack. But right now, Nasdaq isn't showing any sign of faltering.

The surge is being led by the high-tech giants, all of which are cash rich (more so after U.S. tax reform) and showing no signs of slowing down, even though they have reached the stage of maturity when growth rates tend to ease back.

Look at Amazon.com (NDQ: AMAZ) for example. First-quarter sales increased by an astounding 43% to $51 billion, compared with $35.7 billion in the first quarter of 2017 (figures in U.S. dollars). Operating income was up 92% to $1.9 billion, compared with $1 billion in the first quarter of 2017.

Even net income forged ahead. This has always been on the weak side because the company reinvests so much of its cash flow in growing the business. But in the first quarter net income more than doubled on a year-over-year basis to $1.6 billion ($3.27 per share, fully diluted), compared with $724 million ($1.48 per share), in the first quarter of 2017. And all this despite Donald Trump's vitriolic attacks on the company and his implied threats to find new ways to penalize it, either through increased postal rates, higher taxes, or both.

Why is Amazon doing so well? Founder Jeff Bezos credits continued strong growth to a seven-year head start on the competition and the free rein given to developers to devise leading edge apps and product applications.

The stock took off after the results were released, quickly recovering from the brief slump that follow the Trump twitter storm. The shares hit an all-time high of $1,714.50 on Wednesday before pulling back a little to finish the week at $1,683.99. (We originally recommended Amazon in January 2017 at $817.14).

The shares still have a ridiculously high p/e ratio of 206, which to my mind makes this the most vulnerable of the large tech companies in

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Nasdaq – continued from page 1…

the event of a correction. That's why I suggested taking half profits in April. If you didn't do so then, I suggest you act now. Take your original stake off the table and then sit back and enjoy any future growth without worrying about a loss.

When I first recommended Amazon, I predicted it would eventually be the largest retailer in the world. At the time, it was sitting at number five. According to Forbes, in 2017 it moved into the number three position, behind only Walmart and CVS. Only two more worlds to conquer!

Another Nasdaq heavyweight that hit an all-time high last week was Apple (NDQ: AAPL), which touched $194.20 on Thursday. Its revenue growth is nowhere near as spectacular as that of Amazon, but the earnings performance is much superior, as is the company's willingness to share its success with investors.

Second-quarter 2018 results (to March 31) showed a 16% year-over-year revenue increase to $61.1 billion, of which 65% was from international sales. Earnings per share were the best ever for the March quarter at $2.73 fully diluted. That was up 30% from the same period a year ago

Luca Maestri, Apple's chief financial officer, praised the tax reform bill signed just before Christmas as making it feasible for the company to repatriate billions in cash held overseas. "With the greater flexibility we now have from access to our global cash, we can more efficiently invest in our U.S. operations and work toward a more optimal capital structure," he said. That should be music to President Trump's ears.

Apple announced an increase of 16% in its quarterly dividend, to $0.73 per share ($2.92 per year). Amazon, by contrast, does not pay a dividend. As well, Apple is actively repurchasing its shares in the open market. The company will complete the execution of the previous $210 billion share repurchase authorization during the third fiscal quarter and has obtained permission to spend another $100 million on buybacks.

When it comes to fundamentals, Apple looks much more attractive than Amazon to a conservative investor. Its trailing p/e ratio is a relatively modest 18.3, the lowest among the major high-term companies, including Microsoft and IBM. On that basis, Apple is still a Buy.

Of course, there are many more stocks driving the Nasdaq boom, including Twitter, Facebook, Alphabet, Axon, Adobe, and more. Clearly, not all are hitting record highs each week. But enough are to make the Nasdaq Composite the top-performing major index in the world over the past five years. No one else even comes close.

Will it all collapse again, as it did in 2000? Possibly, but I think not. There will be corrections, certainly. But the underlying strength of the key performers is much stronger now than back in the Wild West days of the 1990s when the Internet was in its infancy and any good story was worth millions of investor dollars.

HOW WARREN BUFFETT PICKS STOCKS

We are joined this week by contributing editor Shawn Allen. He is a great admirer of Warren Buffett and today he shares some of Buffett's secrets for finding great stocks. 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.

Shawn Allen writes:

Here is how Warren Buffett described in his Feb. 29, 2008 letter to shareholders what he (and his long-time partner and vice chairman, Charlie Munger) look for in a company to buy outright or to invest in.

Charlie and I look for companies that have a) a business we understand; b) favorable long-term economics; c) able and trustworthy management; and d) a sensible price tag.

This succinct sentence has appeared virtually verbatim many times over the decades in Berkshire's annual reports. Of course, Buffett has elaborated on his criteria for selecting investments many times and has further explained each of the four criteria in the above sentence.

In his 2008 letter, Buffett went on to say:

A truly great business must have an enduring moat that protects excellent returns on invested capital. The dynamics of capitalism guarantee that competitors will repeatedly assault any business castle that is earning high returns. Therefore, a formidable barrier such as a company's being the low-cost producer (GEICO, Costco) or possessing a powerful world-wide brand (Coca-Cola, Gillette, American Express) is essential for sustained success. Business history is filled with Roman Candles, companies whose moats proved illusory and were soon crossed.

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Buffett – continued from page 2…

Our criterion of enduring causes us to rule out companies in industries prone to rapid and continuous change. Though capitalism's creative destruction is highly beneficial for society, it precludes investment certainty. A moat that must be continuously rebuilt will eventually be no moat at all.

More recently in his 2013 letter to shareholders, Warren Buffett said:

When Charlie and I buy stocks – which we think of as small portions of businesses – our analysis is very similar to that which we use in buying entire businesses. We first have to decide whether we can sensibly estimate an earnings range for five years out, or more. If the answer is yes, we will buy the stock (or business) if it sells at a reasonable price in relation to the bottom boundary of our estimate. If, however, we lack the ability to estimate future earnings – which is usually the case – we simply move on to other prospects. In the 54 years we have worked together, we have never foregone an attractive purchase because of the macro or political environment, or the views of other people. In fact, these subjects never come up when we make decisions.

It's vital, however, that we recognize the perimeter of our circle of competence and stay well inside of it. Even then, we will make some mistakes, both with stocks and businesses. But they will not be the disasters that occur, for example, when a long-rising market induces purchases that are based on anticipated price behavior and a desire to be where the action is.

In my updates below, I will assess each company against Buffett's four criteria. Since I am on the topic of Buffett, I will start with Berkshire and have included more details about this fascinating giant.

SHAWN ALLEN'S UPDATES

Berkshire Hathaway Inc. (NYSE: BRK.B)

Originally recommended on April 4/16 (#21614) at $143.79. Closed Friday at $196.01. (Figures in U.S. dollars.)

Background: Berkshire is the giant conglomerate and investment company that has been built up by Warren Buffett since he took control of the former textile company in 1965. It's now number three on the Fortune 500 list by revenue and in 2017 was second only to Apple in annual profit.

Berkshire's most important operating segment is insurance. It insures individuals and businesses directly and also has huge "reinsurance" operations where it provides insurance to other insurance companies. Direct personal auto (GEICO) and the reinsurance of property, casualty and life including insuring against catastrophic events (such as hurricanes) are Berkshire's largest insurance areas and it also has large direct operations involving workers' compensation and medical malpractice. Interestingly, Berkshire does not directly offer home or life insurance.

Most insurance premiums collected are expected to eventually be paid out in claims. However, due the time lag involved, these funds, known as "float", are "temporarily" available to fund investments. Berkshire now has $114 billion in float. Because new premiums typically come in the door slightly faster than claims are paid out, Berkshire's float constantly regenerates and grows and has provided an essentially permanent source of investment funds.

Berkshire uses float along with its own vast share owner equity (currently $358 billion) to invest in numerous wholly owned subsidiaries, a vast cash hoard of $106 billion, equity investments of $184 billion, and fixed income investments of $20 billion. Total assets are $703 billion.

You might be shocked to learn some of the companies or brand names that you are likely familiar with are owned by Berkshire. These include GEICO, NetJets, Dairy Queen, Procor rail cars, Fruit of the Loom underwear, Pampered Chef, and Benjamin Moore paint stores. Berkshire also has large investments in such familiar brands as Kraft, Heinz, Tim Hortons, Burger King, Coke, American Express, Wells Fargo, Bank of America, and Apple.

Given Canada's huge struggle to simply twin the 715-mile Trans Mountain pipeline, I was intrigued to read that a pipeline company that Berkshire owns called Northern Natural Gas is substantially larger than Trans Mountain at 6,300 miles of mainline plus 8,400 miles of branch lines. This relatively unknown subsidiary of Berkshire actually rivals the size of TransCanada's Mainline which is 8,770 miles.

All told, Berkshire's vast array of subsidiary companies now employ 377,000 people including a remarkably tiny crew of just 26 at head office.

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Shawn Allen's updates – continued from page 3…

Performance: The shares hit an all-time high of $217.62 in January before pulling back to the current level.

Recent earnings: In 2017 operating earnings per share (which exclude volatile investment gains or losses and a massive 2017 income tax gain) were down 18%. This was mostly due to losses in its insurance operations primarily associated with three major hurricanes in the U.S., including Puerto Rico, and wildfires in California. However, in the first quarter of this year, operating earnings were up 49% with improvements in all major segments.

Value ratios: Analyzed at Wednesday's closing price of $193.99. The price to book value ratio seems reasonable at 1.38. However, keep in mind that its cash and its large investment portfolio (together representing about 40% of assets) are already fully marked to market and therefore worth only book value. Buffett has indicated on several occasions in recent years that Berkshire's intrinsic value far exceeds its book value and that the difference has widened in recent years. Berkshire will buy back shares if the price dips below 120% of book value. That means at a price below $169. This provides some downside protection.

Given the inherent volatility of Berkshire's earnings, for adjusted earnings I assume 10% of book value on the basis that it has grown at an average of about 10% in the past ten years after reflecting investment gains. On this basis, the adjusted p/e is reasonably attractive at 13.8. However, the forward p/e based on analyst earnings estimates is not attractive at 19.8.

Outlook: It seems likely that Berkshire will continue to grow its size and earnings at an acceptable rate in the future. However, this would likely be in the range of perhaps 10% per year and not the huge growth of bygone years.

Conclusion: While Berkshire is certainly understandable to Buffett, it is a huge conglomerate and most investors could not claim to have a strong understanding of the company. In terms of favorable long-term economics, Buffett has spent over 50 years building up Berkshire exclusively from companies and investments that, at least at the time of purchase, passed his tests. The company certainly has able and ethical management and it also has able and ethical lieutenants in the wings to take over for Buffett. And I believe Berkshire is trading at a sensible price given Buffett's comments on valuation and based on my analysis in the value ratios section above. Ultimately, to buy Berkshire is to place trust in Buffett and to have confidence that he has built the company to thrive after he is no longer CEO.

Action: Buy or continue to hold.

Visa Inc. (NYSE: V)

Originally recommended on Jan. 17/17 (#21704) at $81.84. Closed Friday at $134.74. (Figures in U.S. dollars.)

Background: Visa operates the world's largest retail electronic payment system. This includes consumer credit, debit, prepaid, and commercial payments. Visa Inc. itself does not issue credit cards – they are issued under license mostly by banks. Visa processes most of the transactions and effectively collects license fees and "toll charges" on every Visa transaction – of which there were 111 billion in fiscal 2017!

Performance: Visa's stock has been steadily trending higher for the past five years and the shares hit an all-time high last week.

Economics of the business: Visa has extraordinarily favorable economics. Its lucrative license fees, which card issuers recoup by charging percentage-of-purchase fees to merchants, are largely unregulated in the U.S. and most other countries. Over its 60-year history, Visa has managed to position itself in a very dominant position as a "middleman" between consumers and merchants. Because its systems are almost entirely automated it benefits greatly from scale as increased payment volumes often generate little or no incremental costs.

Visa reports that in 2016 global digital payments exceeded cash payments for the first time in history. With a dominant market share and with the ever-expanding use of digital payments, Visa's economics seem likely to remain strong for the long term. The extraordinarily great economics of its business are also demonstrated by the fact that its 2017 net profits amounted to 48% of revenue and generated a 29% return on equity.

Understandability of the business: At a high level, Visa probably qualifies as a relatively simple and understandable business. On the other hand, very few investors would claim to have much knowledge of the details of how Visa works or of all the risks it faces. Ultimately whether a business is understandable is in the eye of the beholder and depends on what Buffett calls the individual investor's circle of competence.

Recent earnings growth: Adjusted earnings growth in the quarter ended March 31 was 29% which included a significant boost from lower U.S. income tax rates.

Dividend policy: The shares pay a quarterly dividend of $0.21 ($0.78 per year). The dividend yield is 0.6%.

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Shawn Allen's updates – continued from page 4…

Valuation: Analyzed at Wednesday's closing price of $136.28. The price to book value is nominally unattractive at 9.3. But this is not a company that is valued for its assets. The trailing price to adjusted earnings (p/e) ratio at 34 seems unattractive. Based on expected earnings growth, analysts have calculated a forward p/e ratio of 26.

The dividend yield is very low at 0.6% partly due to the low earnings payout ratio of 21%. The adjusted return on owner's book equity (ROE) is extremely good at 29%. Earnings per share growth in the past five fiscal years was very strong at 17%. Assuming that earnings per share grow at 15% annually for five years and the p/e declines to 20, I calculate an intrinsic value per share of $119. The stock could be considered undervalued if we assume that the p/e will remain at say 25 or higher and that growth will continue to be in the range of 15% annually. Overall, Visa is richly valued but this is arguably justified by its extremely favorable profitability.

Outlook: The company has projected that adjusted earnings per share will rise at about 28% for the next two quarters partly due to a 10% boost related to lower income tax rates.

Conclusion: Visa arguably qualifies as an understandable company. It certainly qualifies as having favorable long-term economics and it has able and ethical management. I would judge its current price to be at the upper end but perhaps still within a sensible range given its near-term and longer-term growth outlook.

Action now: Continue to Hold. However, more cautious investors may wish to trim the position.

American Express Company (NYSE: AXP)

Originally recommended on Feb. 17/14 (#21407) at $89. Closed Friday at $101. (All figure in U.S. dollars.)

Background: American Express is a credit and charge card issuer and processor. Most of its customers pay off their cards monthly and so the company is more of a payments processor than a source of lending. Some 62% of its revenues are from the discount fees that it charges to merchants, which average 2.43%. About three-quarters of its revenues and earnings derive from the U.S. Its market share of credit cards in circulation globally (excluding China) is only 2.2% but it has a 9.2% share of total payments.

Performance: After a slump in February, the stock has rebounded and is currently trading just below its all-time high.

Economics of the business: Like Visa, American Express has wonderful economics as it acts like something of an electronic toll booth on its 9.2% share of a massive market. As a smaller player that charges higher fees to merchants than do the bank issuers of Visa cards, it is perhaps less certain that American Express will be able to defend its market share and profitability. Nevertheless, it is still growing, and it seems likely that it will continue to be very profitable into the future. Buffett has often praised the company and Berkshire owns 18% of its shares.

Recent earnings growth: Amex's adjusted earnings per share have surged about 50% in the past nine months including 39% in the latest quarter. This came after several quarters of declining earnings due to the loss of the Costco co-branded card in 2016

Valuation: Based on my analysis price of $100.99, Amex is trading at 15.4 times trailing adjusted earnings and 13.9 times management's 2018 earnings per share forecast. Its return on equity is very high at 31%. Reflecting the elevated ROE, its price to book value ratio is high at 4.8. The dividend yield is low at 1.4% partly because the dividend payout amounts to only 21% of trailing earnings.

Outlook: A strong increase in earnings per share in the order of 20% is predicted for 2018 driven by growth as well as by reduced income taxes.

Conclusion: American Express is arguably simpler to understand than Visa since it is much less reliant on bank partners and is more concentrated in the U.S. Its recent ROE of 31% and its history are a testament to its good economics. American Express has a new CEO, Stephen Squeri, who was promoted from within upon the Feb. 1 retirement of Ken Chenault, who had been CEO since 2001. It would appear that Amex continues to have able and ethical management. With a trailing p/e of 15.4 and an expectation of earnings growth in the range of 20% in 2018, Amex is likely priced at the lower end of a sensible range.

Action now: Buy

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$166.28, US$128.16.

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.

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Shawn Allen's updates – continued from page 5…

Performance: The stock hit an all-time high of $180.21 in February before pulling back to the current level.

Recent developments: Canadian Tire has announced that it will acquire the Helly Hansen brands, which is based in Norway and sells outdoor clothing and related items in 40 countries. The acquisition cost is $1.035 billion which, for context, amounts to about 7% of Canadian Tire's enterprise value.

The company has recently been more focused on building its own proprietary brands and has created a new division to manage its brands. Among other benefits of the acquisition, Canadian Tire indicates that it will enable it to accelerate distribution of its current and future proprietary brands internationally.

Canadian Tire has recently focused on integrating its various retail chains with its "one company, one customer" approach. This includes its new "Triangle" loyalty program.

Valuation: Analyzed at Wednesday's closing price of $168.20. The price to book value ratio seems reasonable to moderately high at 2.6. The dividend yield is modest at 2.1%. The ROE is quite attractive at 15.7%. Adjusted earnings per share growth had been strong for several years but declined 6% in the latest quarter. However, since sales per share were up 9.9% in the latest quarter the growth trend appears to be intact and the decline in earnings was likely an anomaly. The trailing 12 months p/e is reasonable at 15.7.

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).

Conclusion: As a retail business as well as a large issuer of MasterCards, and given its consistent growth, Canadian Tire qualifies as an understandable business. The company also appears to have favorable economics that appear to be enduring. Despite increasing online competition, Canadian Tire has continued to thrive. In my judgement, it has been one of Canada's best managed large public companies over the past decade. In addition to an excellent CEO it has benefited from a strong board under the leadership, since 2007, of Maureen Sabia, who incidentally is the sister of the more high-profile Michael Sabia of the Caisse de Depot.

Action now: Buy.

GORDON PAPE'S UPDATES

TransCanada Corp. (TSX, NYSE: TRP)

Originally recommended by Yola Edwards on April 23/06 (#2616) at C$34.07, US$29.92. Closed Friday at C$54.11, US$41.76.

Background: TransCanada operates a network of natural gas pipelines that extends more than 68,000 kilometres, tapping into virtually all the major gas supply basins in North America. It is also active in power generation with a 31.6% stake in the Bruce Power nuclear plant in Ontario.

Performance: TransCanada shares are off about 17% from their 52-week high of $65.18, reached in late November. This is in line with the general decline in interest-sensitive stocks.

Recent developments: TRP announced strong first-quarter results in late April. Net income attributable to common shares was $734 million ($0.83 per share) compared to $643 million ($0.74 per share) for the same period in 2017.

A number of factors contributed to the higher earnings including contributions from new pipelines that came into operation in 2017 and lower tax rates in the U.S.

As for the controversial Keystone XL pipeline, it is tied up in the court systems of Montana and Nebraska despite having received approval from President Trump. The net result is that we're a long way from seeing shovels in the ground.

Dividend: The company increased its dividend by 10.4% at the start of this year, to $0.69 per quarter ($2.76 per year). The yield at the current price is 5.1%.

Action now: Hold for yield.

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CAE Inc. (TSX, NYSE: CAE)

Originally recommended on March 20/17 (#21712) at C$19.58, US$14.69. Closed Friday at C$27.61, US$21.37.

Background: This company is a world leader in flight simulators. It has customers in 190 countries and 90% of its revenue is derived from international activities and exports. CAE has 160 sites and training locations in 35 countries, representing the world's largest installed base of flight simulators. Each year, the company trains more than 120,000 civil and defence crewmembers.

Performance: The stock moved sharply higher recently after the company reported better than expected results. It hit an all-time high of $27.75 on Thursday before pulling back a bit.

Recent developments: CAE reported stronger than expected results for the fourth quarter and year-end fiscal 2018. Revenue for the final quarter came in at $780.7 million, up 6% from the same period in fiscal 2017. Net income from continuing operations attributable to shareholders was $100.1 million ($0.37 per share) compared to $67.4 million ($0.25 per share) the year before. That was a 48% improvement on a per share basis.

For the full year, the company reported revenue of just over $2.8 billion, up 5% from $2.7 billion the year before. Net income from continuing operations attributable to shareholders was $347 million ($1.29 per share). This includes an income tax recovery related to the U.S. tax reform and net gains on strategic transactions relating to CAE's Asian joint ventures. Excluding these elements, annual earnings per share would have been $1.11. This compares to annual net income before specific items of $278.4 million ($1.03 per share) in fiscal year 2017, and represents an annual EPS increase of 8% over last year.

CAE reported a backlog of $7.8 billion at the end of the fiscal year, up from $7.5 billion the year prior.

The company said the outlook for fiscal 2019 is positive. In its Civil operation, CAE expects double-digit growth in operating income. In Defense, the outlook is for mid-to high single digit improvement.

"Our core markets benefit from strong fundamentals and secular tailwinds, and as we look to the year ahead, we expect CAE to exceed the underlying rate of growth in these markets," said CEO Marc Parent.

Dividend: The shares pay a quarterly dividend of $0.09 each ($0.36 per year) to yield 1.3%.

Action now: Buy. The company is on a roll.

Badger Daylighting (TSX: BAD, OTC: BADFF)

Originally recommended on Nov. 23/14 (#21441) at C$32.77, US$27.72. Closed Friday at C$30.14, US$22.90.

Background: This Calgary-based company has developed a proprietary method for excavating, using pressurized water to liquefy soil, which is then removed with a vacuum system and deposited into a storage tank housed on specialized trucks. This method is especially useful in areas where there are extensive underground pipes and cables since it eliminates the danger of severing vital lines.

Performance: Badger touched a 52-week low of $22.37 in early March but has since rebounded strongly and is now within striking distance of the original recommended price.

Recent developments: The company reported strong first-quarter results. Total revenue came in at $120.6 million, up 20% from just over $100 million in the same period last year. Especially significant was a 29% increase in U.S. revenue to US$67.4 million, or more than half the total. Canadian revenue was ahead 14% to $35.2 million.

In a statement, the company said: "Revenue growth in both markets was due to an increase in overall activity levels and continued growth in the adoption of hydrovac technology. Badger's investment in business development continues to generate ongoing revenue growth, due in part to increased market penetration in both new and existing markets. Average hydrovac rates for the quarter were consistent to modestly higher across both the Canadian and U.S. markets compared to the same period in 2017."

Net profit for the quarter was slightly more than $8 million ($0.22 per share, fully diluted) compared to $3.7 million ($0.10 per share) in the same period the year before.

Cash flow from operating activities before working adjustments was $24.7 million ($0.67 per share) compared to $19.7 million ($0.53 per share) the year before.

Looking ahead, the company said it intends to expand its fleet of hydrovac units this year to between 160 and 200 (up from 140-180 previously). That, in turn, should result in higher revenues.

Dividend: The company recently increased its monthly payout to $0.045 per share ($0.54 per year), from $0.038 previously. The stock yields 1.8%. In addition, the company has received permission from the TSX to proceed with the repurchase of up to two million shares on the open market.

Action now: Buy. The latest results combined with the dividend increase are encouraging.

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