May 2014

Caldwell North American Equity Strategy - Monthly Update

Portfolio Additions

We did not have any new additions to the portfolio in April.

Portfolio Deletions

Zimmer Holdings (ZMH-US)

Reason we sold the stock: As part of its earnings release, Zimmer announced it would be acquiring a company called Bioment. The combined company will hold the No. 2 market share position behind Johnson & Johnson in a $45B musculoskeletal market, and will be the market leader in knees and hips (combined market share of 41% and 35%, respectively). The purchase also expands Zimmer's product offering in some higher growth areas. The acquisition is attractive as it is expected to be double digit accretive to EPS (earnings per share) in its first year as a combined company (2015), and cost synergies are robust given both companies are headquartered in Warsaw, Indiana.

Our investing process has us buy stocks where expectations around a company's future profitability are low (i.e. stocks are cheap) and sell when expectations start running high (i.e. stocks become expensive). To that end, while the announcement is positive for Zimmer, whenever you can get paid today for something good that is expected to happen in the future, it makes sense to take money off the table. This is what we did for our clients on Zimmer as the stock reacted very favorably to the announcement, opening up 18%. We took the opportunity to sell into this strength and locked in double-digit gains for our clients.

Company Updates: A Few Highlights

Energy

The Energy Sector has performed well on higher natural gas and crude oil prices and a weaker Canadian dollar, as these improve energy producers' cash flow and their ability to spend money on energy services. We are very pleased with how our portfolio's energy positions performed (CanElson Drilling +14%, Suncor +9.5% and ShawCor +6%), as they all outpaced the overall performance of the Energy Sector (+5.4%). This speaks to the benefits of how we've structure our clients' portfolios: by having more concentration around each holding (we own approximately 25 stocks), we are able to own the best opportunities the market has to offer.

CCL Industries (CCL.B-t)

CCL reported strong earnings results as revenue grew 68% over last year. While most of the growth was from acquisitions, which continue to perform very well and exceed margin expectations, organic growth was also strong with revenue growing over 4%. CCL has a lot of run room as it is the only player with a global footprint while still having less than 5% market share in the global label market. Strong cash flow generation provides further consolidation opportunities.

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Market Commentary

For those of you that have seen one of our presentations, you know that we spend a lot of time walking through our investment process. This is because the process drives the investment decisions we make for our clients, which ultimately determine investment results. Capital protection serves as the foundation for each step of our investment process and we've seen this important component do its job very well for our investors over the last several months.

While changes in a stock price are ultimately driven by a company's profitability, the shorter term driver of a stock price is **expectations** around the company's **future** profitability. As we touched on with Zimmer, our process has us sell companies when expectations for future prospects start running high. An extension of that is avoiding buying the stocks of companies that must continue to grow at very high rates simply to justify their current share prices (where expectations are very high). There are many such companies in the market and we avoid them because, while the company may turn out to be the next Google or Microsoft, it is more often the case that the high growth the company is currently experiencing starts to fizzle out. In the meantime, confidence/expectations around future growth can change dramatically, causing big swings in stock prices.

There has been a big negative shift in expectations for high growth companies over the last several months which has caused dramatic declines in their share prices [Here is a list of some of the market's worst performers, which also happen to be well known, high growth/exciting companies: Splunk (-47%); Twitter (-40%); Pandora (-40%); Zynga (-36%); Workday (-34%); Groupon (-34%); Rackspace (-31%); NetFlix (-28%); TripAdvisor (-23%); Amazon (-22%)]. Avoiding losses is more than half the battle and we are very pleased that our process highlighted these companies as a high risk and allowed us to avoid substantial losses in our clients' portfolios.

We continue to be selective in the stocks we own for our investors, focusing on stocks that provide compelling value as this not only protects capital, but sets the stage for future capital growth.

For those of you who have not seen one of our presentations, we host them regularly. Please visit our website www.caldwellinvestment.com for all upcoming events.

As always, feel free to contact us with any questions.

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