OUR 41ST YEAR

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June 2018/First Report ♦ Single Copy: $10.00 Volume 42, Issue No.11

THE MONEYLETTER®

STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

Political, Regulatory Noise…

…CREATE OPPORTUNITIES

Elvis Picardo

Political and regulatory risks – broadly defined as risks emanating from the political and/or regulatory environment that can have an adverse impact on a company's prospects and profitability – are among the many threats businesses must deal with and manage. Companies in certain sectors, such as mining and energy, arguably have greater exposure to these risks than those in other sectors. For example, a mining company's flagship project may be stalled indefinitely if it does not receive a key permit, or if a supportive government is supplanted by a hostile one.

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In recent months, however, political and regulatory risks appear to be on the rise, making a growing number of companies in disparate sectors vulnerable to them. Witness the ongoing brouhaha over the expansion of the Trans Mountain pipeline, which has been dubbed one of the most polarizing energy projects in years. Or the General Data Protection Rule (GDPR) that came into effect across the European Union on May 25. Firms that are not in compliance with GDPR – which aims to give individuals more rights over their personal data – face fines of up to 20 million euros or 4 per cent of global annual revenues, whichever is higher. And then there are President Trump's tweets, which can cause short-term volatility in stocks that are the target of his ire.

In some cases, the "noise" from political and regulatory problems can create buying opportunities for the patient investor. The key here is distinguishing which development is a true signal of prolonged or terminal decline for a company's fortunes, and which one is mere noise that could be transitory in nature, and hence prove to be a good buying opportunity.

We highlight here two stocks that we believe are textbook examples of buying opportunities

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created by political/regulatory noise. Both stocks are presently in our clients' investment portfolios.

Hydro One

Exhibit 1 is Hydro One* (TSX: H, $19.65), one of the largest electric utilities in North America. Its transmission network serves most of Ontario, which is home to 38 per cent of Canada's population. While rising bond yields have taken their toll on the Canadian utility sector, which is down almost 10 per cent for the year, Hydro One has also been affected by its emergence as a hot-button issue in Ontario's upcoming provincial elections.

Consumers in Ontario pay higher rates for their power than those in any other province. The Globe and Mail notes that since 2006, the top rate for power in Ontario has surged four times faster than inflation. In a July 2017 report, the Fraser Institute stated that Toronto had the highest hydro rates across Canada, with the average monthly residential hydro bill $60 higher than the national average.

Hydro One was partially privatized in November 2015, when the utility had its initial public offering. The province of Ontario still owns 47 per cent of Hydro One, giving it a significant degree of control over the company.

Capitalizing on consumers' dissatisfaction with the utility, Ontario Progressive Conservative party leader Doug Ford has vowed to fire the CEO and Board of Directors of Hydro One if his party comes to power. Ford has labelled Hydro One CEO Mayo Schmidt the "six million-dollar man," based on Schmidt's total compensation of $6.2 million in 2017. Earlier in May, Hydro One's negative news flow continued, with reports that the company's executives and directors had awarded themselves a $25,000 annual pay hike, bringing annual compensation for directors to $185,000.

On the positive side, Hydro One is the quintessential defensive utility investment, since 99 per cent of its revenues are derived from regulated operations. It recently raised its quarterly dividend by about 5 per cent to $0.23 per share, for an indicated dividend yield of 4.7 per cent. The stock's 11 per cent decline this year provides a good entry point, as it trades at about 14 times analysts' average EPS estimate of $1.38 for 2019 (source: FactSet).

We view the pending acquisition of Avista Corp – a regulated utility with headquarters in Spokane, Washington, and operations in five U.S. states – as a near-term catalyst for the stock. The acquisition increases Hydro One's geographic and asset diversification, and the company expects it to be accretive to EPS in the mid-single digits in the first full year of operation. Post-acquisition, Hydro One expects to continue growing its dividend and maintain its targeted payout ratio of 70 per cent to 80 percent. Industrial Alliance Securities (of which HollisWealth is a division) rates the stock as a Buy with a $26 price target.

QUALCOMM

Exhibit 2 is QUALCOMM Inc. (NASDAQ: QCOM, $59.96), the world's biggest provider of mobile chips. Qualcomm also holds a massive portfolio of patents relating to technology that connects cellphones to cellular networks. In October 2016, Qualcomm bid $47 billion for Dutch chipmaker NXP Semiconductors - a leader in automotive chips and secure identification to solidify its leadership in new 5G wireless technology and diversify into new areas. The deal is still in limbo; while Qualcomm has received approval from eight of the nine required regulators globally, China has yet to approve the deal.

Over the past couple of years, smartphone makers including Apple and Samsung have challenged Qualcomm's licensing practices, since it charges a license fee based on the value of the phone and not its components. Apple, one of Qualcomm's largest customers, had sued the company more than a year ago on grounds that it should pay a fee based only on the value of Qualcomm's connectivity chips and not the entire cellphone. In a bid to resolve the licensing dispute, Qualcomm recently lowered the price cap on which its royalties are based by $100 per phone, to $400.

Several rapidly unfolding developments have resulted in Qualcomm's price chart resembling a roller-coaster ride in recent months. The license dispute with Apple and other cellphone manufacturers had dragged Qualcomm's stock price down to a 19-month low to just below $50 in September 2017. In the first week of November 2017, Qualcomm surged after Broadcom made an unsolicited $103-billion offer to buy the company.

On March 12, 2018, President Trump blocked the proposed deal between the two companies, citing national security concerns. Meanwhile, Qualcomm is in the crosshairs of the simmering trade war between U.S. and China.

In April, the U.S. Department of Commerce slapped a seven-year ban on component sales to Chinese phone maker ZTE by American suppliers, because ZTE had violated trade restrictions on Iran. The impact on Qualcomm is twofold. Most ZTE smartphones use Qualcomm processors, so an inability to sell to ZTE would dent Qualcomm's revenues by about 2 per cent. As well, China could block the Qualcomm-NXP deal in retaliation against the U.S. ban on ZTE.

As a result, Qualcomm's stock has become something of a proxy for measuring the ebb and flow of trade tensions between the world's two largest economies. Lately, the tone of exchanges between the two nations has become more conciliatory, and tensions appear to have lessened. On May 26, President Trump said that the U.S. would allow ZTE to remain in business after it pays a $1.3-billion fine, changes its management and board, and provides high-level security guarantees.

That news has been positive for Qualcomm, which is also getting a lift from a new $10-billion stock repurchase authorization announced by the company on May 9. Qualcomm recently reaffirmed its guidance for fiscal 2019 non-GAAP EPS of $5.25 (which includes $1.50 EPS accretion from NXP), growing to $6.75 - $7.50 upon resolution of licensing disputes.

A resolution of its licensing dispute with Apple this year would imply that the stock is trading at a forward P/E multiple of between 8 and 9, a compelling multiple for a large-cap technology stock. With a number of cata-

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STOCK STRATEGY

Sector Outlook

RETAIL RISING

Stephen Bernhut

Now that you actually can have breakfast at Tiffany's, and that you'll soon be able to walk into a store and buy marijuana, you might ask yourself what surprises the retail sector has in store for you next. If your answer is a better ROI on your stocks than last year, your prayers might just be answered.

While 2017 was by any an annus horribilus for the industry, you'd be hard pressed to find a retailer who had an even decent year. And why not? In the U.S., about 7,000 stores were shuttered, led by Walgreens (600) and Kmart and Sears (300). Bankruptcies were up considerably, and included established names such as Toys 'R' Us and Radio Shack. In Canada, Sears Canada, Danier Leather and Gymboree all closed shop.

But if it was a wobbly year for retailing, it was an even shakier year for retailers. Most felt under siege, on the one hand responding to the significant migration of brick and mortar consumer to online shopping, and on the other, understanding that the in-store experience had to be richer, with less emphasis on shopping, and more emphasis on entertainment, hospitality and community.

The buzzword was – and remains – "Experiential." (Given the wide media attention to shoppers' migration to cyberspace, it is interesting to note that online purchases account for only 10 per cent of total retail sales). But not every retailer has the savvy to personalize and curate merchandise the way shoppers want. And how many retailers can match the experience of the NFL Experience in Times Square, which allows a fan to suit up and call plays like Tom Brady? (NOTE: While Starbuck's has never been a contrarian, it's interesting to note that it took down its online store in the fall of 2017, with Chairman Howard noting that, "Every retailer that's going to win in this environment must become an experiential destination. Your products and services, for the most part, cannot be available online or on Amazon.").

Despite the disruption and hand

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Stephen Bernhut is a Toronto investment writer.

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lysts on the horizon for Qualcomm, we believe the stock should be in a good position to make up for lost ground in relation to its peers over the rest of the year, as the noise dissipates and attention returns to its solid fundamentals.

Disclosures: * Industrial Alliance Securities is a member of Hydro One's underwriting syndicate. HollisWealth clients hold shares of Hydro One and Qualcomm in their portfolios. Elvis Picardo holds shares of Hydro One in his personal accounts.

This information has been prepared by Elvis Picardo, Portfolio Manager, HollisWealth®, and does not necessarily reflect the opinion of HollisWealth®.

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Bling – Notes From Underground

GOLDCORP

Goldcorp Inc. continues to deliver on its five-year production plan, extending from 2017 to 2021, according to CIBC World Markets analysts David Haughton and Terry K.H. Tsui. The goal is 20 per cent production growth, 20 per cent reserve growth and 20 per cent lower all-in sustaining-costs (AISC) from 2016 to 2021, with no merger and acquisitions distractions. Messrs. Haughton and Tsui maintain their Outperformer rating and stamp a US$20 target share price on the stock. (G-TSX, $18.42; GG-NYSE, US$14.17)

The analysts note, "Goldcorp reported 2018 first-quarter adjusted earnings per share (EPS) of $0.08, below our estimate and consensus of $0.10. The first quarter production of 590,000 ounces beat our 575,000-ounce forecast, but by-product cash cost of $511 per ounce exceeded our estimate of $444 per ounce. AISC of $810 per ounce was within annual guidance.

"On the cost-savings front, Goldcorp had achieved nearly $210 million of the $250 million sustainable cost-cutting program by the end of the first quarter, and is looking to go beyond the current target (over $250 million identified). "The greatest risk to the price target is the outlook for bullion prices. Also, the price target is based on mine operations continuing without interruptions, keeping in mind that mining is an inherently risky business."

Goldcorp also has exposure to the Canadian dollar, Mexican peso and the Argentine peso, which affects costs and the price target.

Goldcorp is North America's third-largest gold producer.

Stephen Bernhut is a Toronto investment writer.

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Vol. 42, No. 11 **June 2018/First Report**

Subscription Rate: $167.00 per year. Single copies: $10.00 each. Quantity rates on application.

*The MoneyLetter** is published twice a month by MPL Communications Inc.

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ISSN 0703-7613 Printed in Canada