

Blue chips found in the bargain bin



Manager: Alex Davidson, JC Clark Ltd.

Fund: JC Clark Patriot Trust (Class B)

Description: Long-biased fund that invests in North American equities, focused on the preservation of capital and superior long-term returns

AUM: \$40-million

Performance: 1-year -2.61%, 3-year +13.28%, 5-year +8.50% (as of October 31, 2011)

Fees: Management 2%, Performance 20% (10% hurdle rate)

Alex Davidson, manager of the JC Clark Patriot Trust, said private investors and professional money managers have sold off solid, blue-chip stocks. "Not in the past 40 years have blue-chip equities been this inexpensive."

Financial Post · Dec. 9, 2011

In volatile times like this, private investors often sell due to fear, while professional money managers do so to raise liquidity and mitigate risk. This has created an incredible buying opportunity in blue-chip stocks, says Alex Davidson, manager of the JC Clark Patriot Trust. "Not in the past 40 years have blue-chip equities been this inexpensive. Coupled with that are incredible balance sheets, many of which have extraordinary amounts of cash."

A bonus comes in the form of dividends, as the Dow Jones Industrial Average currently offers a yield of almost 2.8%, which compares favourably against U.S. 10-year treasuries currently yielding below 2%. "Traditionally, investors have looked for extraordinary returns through investment in the small-and mid-cap sectors. You don't need to assume that added risk when blue chips will probably give you superior returns going forward, as well as a solid yield."

The hedge fund manager notes that while certain areas of the market offer very compelling yields, most of those companies are not backstopped by the kinds of balance sheets and global recognition that blue chips are. Davidson targets a yield of between 2.5% and 3.5% for Patriot Trust, which makes his goal of achieving an annual compound return of 10% over the long haul easier to achieve.

The manager relies heavily on fundamental analysis when building the portfolio, and utilizes his three decades of experience owning and operating manufacturing and resource companies when identifying potential investments. After finding an attractive company, Davidson typically evaluates the health of the underlying sector to determine if the outlooks correspond. "If it doesn't,

we might short that sector while retaining a long position in the individual company to mitigate some of the sector risk that is more difficult to assess at times," he says. This strategy of shorting sector and index ETFs is part of an effort to preserve capital and dampen the volatility of the portfolio.

The fund is overweight the energy sector, due in part to the persistent demand pressure from the ever-growing middle class population across the emerging markets. Davidson also touts the success of revolutionary technologies such as horizontal multi-frac drilling, which now accounts for roughly 90% of North American activity. The manager is also a big believer in technology and says he would be a buyer of most household names in the sector. "Ever since the bubble in 2000, the technology sector has been profoundly undervalued, particularly the big cap names," he says. "I feel comfortable that over the next ten years, investors will do very well in them."

BUYS

BAYTEX ENERGY CORP. Ticker BTE/TSX

The position: Long-term holding.

Why do you like it? This heavy oil producer may not be cheap, but Davidson thinks it is worth the premium.

"The company has done a wonderful job managing assets that didn't look particularly attractive several years ago," Davidson says.

"It is doing a great job utilizing technology to stimulate heavy oil production through such techniques as multi-lateral horizontal drilling and cyclic steam stimulation. Baytex also offers a 5% dividend yield.

Biggest risk: A serious decline in the price of oil and a strong Canadian dollar.

VODAFONE GROUP PLC Ticker VOD/NASDAQ

The position: Long-term holding.

Why do you like it? This U.K.-based telecom services provider has more than 360 million customers across 30 countries.

"They are expanding, gaining market share and will generate free cash flow of more than US\$9.5-billion on a standalone basis," Davidson says.

"At the same time, the stock offers a compelling P/E multiple of only 8.5x projected earnings for next year." But what is really interesting is Vodafone's 45% stake in Verizon Wireless, which recently declared an initial dividend of US\$10-billion.

Davidson notes that Vodafone intends to pay out its share of the Verizon dividend, and when combined with its existing dividend, it will add up to a yield of more than 8%.

"Most of us expect that is going to be a recurring dividend policy for Verizon," he says.

Biggest risk: Domestic competitors may capture market share more inexpensively in emerging markets. The company also has large exposure to Europe.

INTERDIGITAL INC. Ticker IDCC/NASDAQ

The position: Event-driven opportunity.

Why do you like it? InterDigital develops mobile technology, patents it, then licenses it to companies such as Google, Apple, Microsoft and Samsung.

Davidson points out that it has 19,000 registered patents, 190 engineers and US\$700-million in cash sitting on its balance sheet. Applying the metrics that Nortel's patent portfolio was sold for earlier in 2011, he estimates that would produce a share price of roughly US\$120 for InterDigital.

Interdigital is currently trading in the low US\$40s. However, unlike Nortel, InterDigital's patents are concentrated in emerging 3G and 4G LTD mobile networks, making them far more attractive.

Biggest risk: "I believe the downside if nothing evolves from the sale is probably 20% of the stock price, but the upside is a double or better."

SELL

CANADIAN BANKS

The position: Short position using the iShares S&P/TSX Capped Financials Index Fund (XFN/TSX).

Why don't you like it? For some time now, Davidson has supported his negative view of Canadian banks by maintaining a modest short position in the XFN ETF.

"We acknowledge that Canadian banks are well managed and that their capital ratios are excellent," he says.

"However, we think that their valuations are too high relative to their intermediate growth prospects. We are also somewhat concerned with the sustainability of housing prices and investment banking activity, as well as the substantial exposure of several banks to the American market."

A potential positive? Interest rates rise sooner than expected, Canadian household debt is reduced, and housing prices continue to appreciate.