Issue 15

PALOS
INVESTMENT FUNDS

April 13, 2017

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Palos Weekly Commentary

■ Palos Income Fund

By Charles Marleau

Boy O'Boyd

Boyd Group Income Fund (TSX:BYD-U) is one of the leading and largest operators of collision repairs in North America. It is the only public company in the North American automotive collision repair industry. Its revenue is recession resilient as 90% comes from insurance companies. Car accidents happen regardless of the state of the economy and insurance companies must pay the bill. Therefore, even in a recession, revenues are guaranteed.

Over the years, BYD organically developed and acquired 404 centers in North America. The centers offer collision, glass repair and replacement services. Its strength, however, comes from its relationships with insurance companies which are maintained by way of their strong management system technology. The filing and managing of insurance claims is drastically simplified thanks to this system. BYD also has multiple locations which is preferred by insurers as it helps with customer satisfaction.

The industry continues to be heavily fragmented and BYD will continue to gain market share through acquisitions and service. BYD continues to acquire single shops at 4X EV/EBITDA which is immediately accretive to FCF. The new facilities acquired usually have earning and strategic upsides as they get integrated into the Boyd family of facilities. After integration, utilization typically increases significantly as insurance companies send more business to the facilities than if they were standalone shops. We believe BYD is well-positioned to continue, and even accelerate, its acquisition strategy, especially considering its $55 million cash position, its $250 million revolver and the fact that it trades at 0.9x Net Debt/EBITDA. BYD has a lot of room for M&A opportunities.

Boyd's balance sheet also brings about another opportunity in the form of financial engineering. We don't invest in companies purely because they may be M&A targets. However, in the case of BYD, the industry has been active in the financial market. Leonard Green and Partners LP, a private equity fund, has been active in the space. A few months ago, they acquired 25% of Caliber Collision, their intentions are unknown. Secondly, Service King, owned by Blackstone and friends,

Chart 1: Palos Domestic Funds versus Benchmarks (Total Returns)*

	FundServ	NAVPS	YTD Returns
Palos Income Fund L.P.	PAL 100	$9.76	2.05%
Palos Equity Income Fund - RRSP	PAL 101	$6.41	2.13%
Palos Merchant Fund L.P. (Dec 31, 2016)	PAL 500	$4.33	-16.73%
Palos IOU High Yield Fund (Feb 28, 2017)	PAL 701	US $7.37	-1.40%
Palos WP Growth Fund - RRSP (Apr 13, 2017)	PAL200	$9.94	-0.59%
S&P TSX Composite			2.57%
S&P 500			5.08%
S&P TSX Venture			9.26%
Bloomberg USD High Yield Corporate Bond Index 1 to 3 Year			2.80%

Chart 2: Market Data*

	Value
US Government 10-Year	2.24%
Canadian Government 10-Year	1.49%
Crude Oil Spot	US $53.04
Gold Spot	US $1,285.90
US Gov't10-Year/Moody BAA Corp. Spread	232 bps
USD/CAD Exchange Rate Spot	US $0.7501

* Period ending Apr 13, 2017

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is currently going through a sell process. The industry is attracting Private Equity to the space.

We see BYD more as a target especially with its crystal clean balance sheet. To the best of our knowledge, BYD private peers are 7X EBITDA in leverage. This makes BYD an easy LBO candidate.

We believe BYD is a compelling investment as it will continue to grow and acquire individual centers. The company has attained a level where it can keep growing and significantly increasing dividends in the coming years. In addition, there is possibility that the company could get acquired.

■ What is New on the Macro Level?

By Hubert Marleau

Enough Time has Passed to Forget

An economy is a messy and complicated system. Therefore, it is imperative to have a well-thought-out model that is evidence-based and incorporates the financial history of markets. A good macro-built model will automate decision making, provide a margin of safety and suggest better portfolio rebalancing and rotation while eliminating impulsive mistakes and emotional knee-jerk reactions. It goes without saying that there are no perfect models and, as such, they need to be constantly adjusted to reflect new data, new studies and new ideas. Nevertheless, investors should stick with the knitting. There is an old saying that people don't go to church on Sundays to learn a new commandment. They go to reinforce the ten commandments that are already in place. In this connection, we subscribe to the hypothesis that over the long-term, stock market returns reflect the performance of the economy. Unfortunately, the relationship for stock market returns is not linear and will, for various reasons, either over or underperform the pace of economic activity; mean reversion is however observable. Stock prices are subject to three types of movements: erratic, cyclical and secular. Firstly, erratic movements are instant daily changes that are caused by media noises and news. These wandering prices are better left to high frequency traders. Secondly, secular movements are caused by trends that reflect the long-term rate of change in national income, which is derived from secular changes in population growth, productivity and inflation. For example, we are banking on the prediction that over the next decade, the U.S. GDP, in nominal terms, will grow around 4%. It may do slightly better if the U.S. economy experiences an increase in productivity. Thirdly, cyclical forces can cause stock market returns to diverge from the long-term pace of economic activity. As a rule, stock market return deviates from a definable secular trend when: 1) the cost of money is far away from the neutral policy rate, 2) the price of oil is nowhere near the marginal cost of extraction and 3) the profitability of the economy is abnormal. In the year ended March 2017, the S&P 500 registered an increase of 15%. During this period, these components were in excellent shape. The cost of money was way lower than the calculable neutral policy rate, the price of oil was significantly below the estimated marginal cost of production and corporate profit margins were rising to historical highs.

Barring changes in valuation metrics and geopolitical risks, herein lies the future. In our judgment, one of the ingredients will change. The U.S. monetary policy is gearing down. It should be noted that we are maintaining the position that: 1) the price of oil should stay below its marginal cost for the rest of 2017 and 2) profit margins should do well as wage rates and input costs are not rising as fast as selling prices. There is always a possibility that the two latter cyclical forces might turn. On the one hand, the oil glut could disappear faster than predicted if OPEC's agreement to cut production is successfully extended for another six months. Corporate profit margins are however not yet likely to revert to the mean because pricing power remains relatively favorable. This explains why business sentiment and confidence are high.

There is plenty of empirical evidence to support the proposition that it takes about seven to nine years for market participants, including central banks, to forget the last financial crisis. The last one ended in March of 2009. From 2009 to 2015, the editorial sections of newspapers saved a lot of space for commentaries on the crisis and book stores filled their shelves with books that explained the causes of the crisis. On December 15, 2015, the Fed tried to change the direction of its monetary stance when it lifted the medium federal funds rate to 0.375%. Their effort failed. The rate of inflation was below the 2% target rate and there was plenty of slack left in the labor market.

Lately, the monetary authorities have shown greater openness to strategic considerations rather than simply depending on short term economic data points. Accordingly, in December of 2016 and again in March of 2017, the monetary authorities hiked their policy rate. Today, the

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medium policy rate is 0.875%. We expect two more increases in 2017 because the rate of inflation is at the target rate and the economy is operating at full employment. Interestingly, the Fed has begun to discuss how it should pare down the bank's huge accumulation of bonds. The Fed has yet to come up with a plan but has indicated that it will have one by the end of 2017. The latter point makes common sense to us as long term interest rates appear to be severely out of whack. Given the current state of the U.S. economy, yields on ten-year treasuries should be 3.00% and the Fed's policy rate should not be any higher than 1.50%. The Fed is only playing catch up. By the end of 2017, the adjustments to achieve normalization in the monetary stance will be accomplished. There will be no need to go any further as the economy will be neither hot or cold. It will be just right. The Fed will not trigger a tightening cycle. It just wants to normalize monetary conditions. The reasons for this scenario is predicated on the belief that the growth in nominal GDP is too low, government balance sheets are burdened with too much debt and market participants are sensitively accustomed to an accommodating monetary stance. Moreover, new regulation requires banks to maintain higher reserves. A fast reduction in the monetary base could restrain bank liquidity and force banks to tighten their lending standards. This is not what the Fed wants.

The Effect on the Stock Market

The question is whether the changing recipe will cool the stock market. It may, but not sufficiently to stop its upward secular trend. Assuming that corporate profits were to rise 5% over the next twelve months, that Baa bond yields don't go any higher than 5.50% and that the price of oil stays below $60 a barrel, our calculations show that the fair value for the S&P 500 is 2350. Is there any downside risk? The quick answer is yes. The price of oil is like a fly in the ointment. Next week, we will put together an argument as to why we think that the price of oil is not likely to go much beyond the $60 marginal cost of production.

If you have any questions about the weekly commentary, the securities that we follow, or investment ideas, please contact us at info@palos.ca