Harbour equity funds update
June 2016

Harbour Fund
Harbour Global Equity Corporate Class

Will the U.S. Federal Reserve raise interest rates in June? Will it be before the Brexit vote? What effect will one or two rate increases have on the U.S. dollar? Will such actions induce strains in emerging markets, as was the macro theme of 2015?

These are important questions. However, they miss a critical point – *big things are happening in the world of dishwashers. Yes – dishwashers!*

And so starts a detailed analysis on our recent investment in Whirlpool, the 100-year-old rustbelt heavy-metal banger that happens to be the largest appliance manufacturer in the world.

Our journey to a buy decision involved a detailed process structured around five key questions. Although the actual analysis and due diligence took several weeks to complete, the five questions that form our framework are remarkably simple.

1. Is Whirlpool a good business?

Every investment we make will not be in a "great" business. However, the business at least needs to be decent. This would be an accurate description of Whirlpool. This business has improved dramatically over the years and is not receiving proper credit or valuation – but here I am jumping ahead. We determined that Whirlpool is a decent business due to good returns on invested capital and the extreme unlikelihood that earnings would ever go negative since much of the business is based upon replacement demand. (Even at the depths of the credit crisis, its earnings were positive.) Overall, the business has a reasonably sound moat. It would, after all, be difficult to build another Whirlpool any time soon. On the negative side, margins are fairly low and this can swing earnings. Earnings did not go negative in the credit crisis, but they were cut in half. Margins have migrated from low- to mid-single digits in the old days, to 6-7% currently and, in our opinion, will soon enter the 8-9% range – these numbers are toward the bottom end of our acceptable range.

2. Is management trustworthy and also a good allocator of capital?

Yes, very much so. The long-tenured team at Whirlpool is widely regarded as extremely capable and has never once done anything questionable with regard to capital allocation. Management has a record of excellent cost control and has periodically made smart acquisitions. The management team is a good steward of capital.

3. Is the balance sheet in good shape?

Yes, pristine.

Let's stop here for a moment because the first three items in our framework are very much checklist-type questions and can be answered with relative ease (with the possible exception of the first question). While easy, adhering to these rules keeps the investor out of a heck of a lot of trouble. These questions would have kept investors out of Sun Edison due to its stretched balance sheet, Bombardier due to governance issues, and Sears due to bad business economics.

4. Why is the security mispriced?

Here begins the heavy lifting. It is true that most equities are efficiently priced most of the time. In order to achieve outsized gains there must be some identifiable reason for the opportunity. We believe that Whirlpool is mispriced because although there have been dramatic improvements within the company and industry, they have gotten lost among macro events.

Until 2006, Whirlpool was a very low-margin original equipment manufacturer with low brand recognition. This began to change in 2006 when Whirlpool bought Maytag. The transaction brought about great improvements that were ultimately lost on investors as the housing crisis hit soon after. The appliance business was severely impacted in the downturn and did not begin to recover until 2013. Just as markets were beginning to appreciate and major improvements began to slowly take shape in the industry, Whirlpool was hit hard in 2015 by emerging market and currency trouble. Half of its business is outside North America and its largest emerging market exposure is to Brazil. Again, macro events masked good things happening at Whirlpool, which this time included two major acquisitions at the end of 2014 – one in China and the other in Europe.

The massive cash generating power of the current business simply does not reconcile with a valuation that sits under 10x 2017 earnings.

5. Why do we believe the mispricing will correct within our time horizon?

We believe that Whirlpool is on the cusp of generating much greater cash flow. If we look out to 2020 we believe there will be upwards of $4 billion of cash generated (post dividend) against a current market capitalization of just over $13 billion. We believe that this creates fabulous optionality when combined with Whirlpool's smart management team. Furthermore, we believe it will be difficult for the market to ignore the fact that this industry and business has changed for the better. As the old saying goes, "value will out."

Other portfolio changes

Now that you have probably heard enough about appliances for a while, let me review some other portfolio changes that have taken place since my arrival at the beginning of April. All of the changes are framed against the five key questions previously summarized.

Restructuring of energy holdings
We have made several changes to our energy holdings, including the sales of Patterson Energy (bad business), Canadian Natural Resources (bad business, balance sheet concerns), and Weir Group (bad business). Two of the replacement names we added were TransCanada and Kinder Morgan. TransCanada is a good business with good management and an excellent balance sheet. We believe the market is underappreciating the benefits of a very large recently proposed acquisition. Kinder Morgan is also a good business with good management and a rapidly improving balance sheet. The market is underappreciating the still sizable natural gas infrastructure opportunity for those with existing footprints.

Reduction of cyclicals
We sold luxury goods retailers Tiffany and Richemont. These companies are good businesses with decent management and good balance sheets. However, they are caught in an extremely tough luxury environment and the answer to question five – why do we believe the mispricing will correct within our time horizon – is very tough. As Warren Buffet's business partner Charlie Munger says, "Those ones go in the too hard pile."

Reductions of individual names
This includes Empire, a company that is suffering bigly (as Donald Trump would say) from its botched acquisition of Safeway Canada. The name was right-sized to fit the current risk profile. We also reduced Element Financial, another company that we did not think deserved such a large weight in the fund for a variety of reasons.

Besides Whirlpool and the aforementioned energy names, we also added to our positions in Brookfield Asset Management and Synchrony Financial, and initiated a position in Wells Fargo. I will not go into detail on each of these names; suffice it to say, they all pass the five-question test.

Cash in the portfolios is high, approximately 17% in Harbour Fund and 24% in Harbour Global Equity Corporate Class. This is not an intentional bet against the market but rather a result of the extremely high standards to which we hold each new investment. It was easy to sell positions that gave us discomfort. However, it will take time to find suitable replacements.

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New additions to the Harbour team

We are pleased to welcome Claire Thornhill to Harbour Advisors. Claire brings with her a diverse investing background that I am sure will complement the existing team. In mid-June we will welcome a second new member to the group, Ali Pervez. Ali also possesses skills and industry knowledge that will be additive to the group.

Claire and Ali bring our analyst pool up to six members. Our intention is for the analyst pool to work on finding the best ideas regardless of mandate. As a result, we expect more overlap going forward between the Harbour equity funds and the equity portion of the Harbour Growth and Income funds.

As always, we thank you for your continued support as we work to ensure that the Harbour equity funds reflect our core mandate of providing a conservative offering for clients who seek growth but want to be protected on the downside.

Ryan Fitzgerald, CFA
Senior Portfolio Manager

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