HEWARD
INVESTMENT MANAGEMENT INC.

The Heward Global Leaders Fund and Global Equity Investment Summary August 2018

2018 has been a choppy and volatile year to-date with investors patience and nerves being constantly tested. In the era of 24 hour news, many investors are being influenced by so many negative headlines with knee jerk reactions. Yet markets and stock prices are climbing the "wall-of-worry" as corporate earnings continue to grow at a double-digit rate, economic growth remains healthy and corporate balance sheets are strong, with many management teams having generally positive forward guidance. These factors should propel stocks higher through the end of the year, but we are aware that the investing landscape has turned more volatile in the past six months, a trend we expect to persist. Stocks do not just go up in a straight line forever. Periods of weakness and volatility will occur, and in our view these periods represent an opportunity as long as the fundamentals remain healthy.

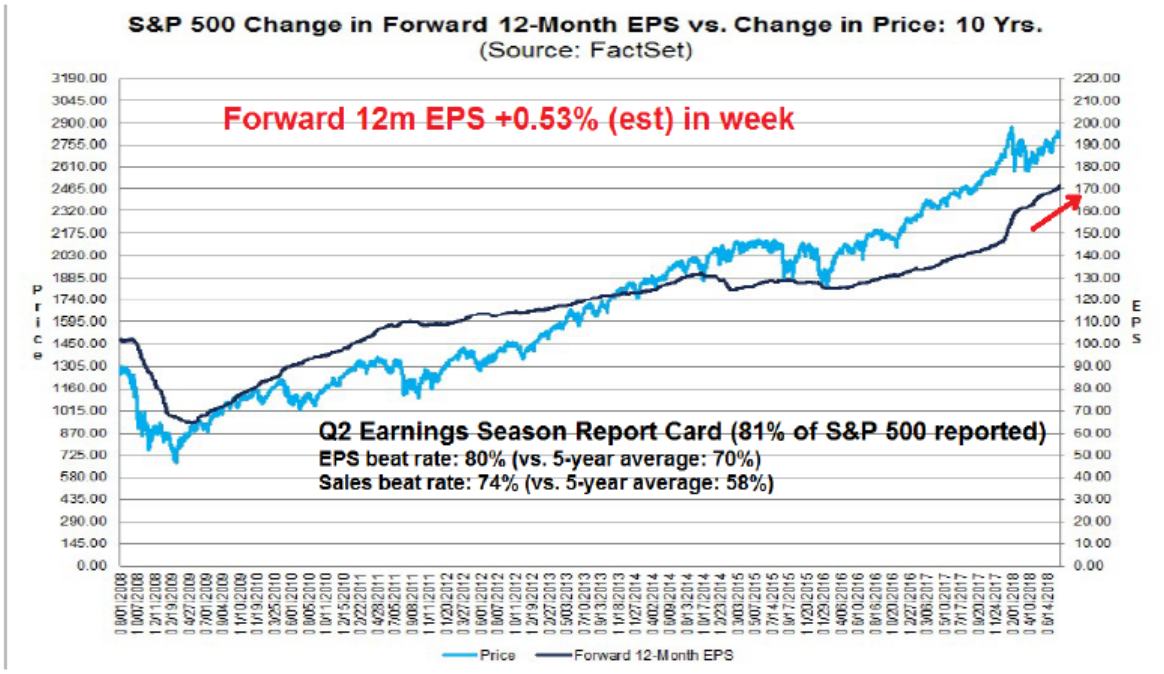
So, what has changed? The second-quarter earnings season has been nothing short of impressive. In the US, corporate earnings on average are up over 27% on back of 10%+ revenue growth. After four consecutive months of underperformance, US Financials rallied in July on the back of solid second-quarter reporting of their earnings with US banks leading the way. Earnings growth expectations for Banks, and Financials overall, moved higher during the month amid positive surprises and upward earnings revisions. Earnings growth over the next 12 months for Financials is estimated to be the strongest across all sectors, after Energy. Given these trends, combined with dividend growth, strong balance sheets, attractive relative valuations, and solid US economic growth (with rising interest rates), we remain very positive on financials into the back half of this year.

The 2019 S&P500 earnings per share consensus estimate has crept up towards ~$178 according to Bloomberg and on that number the PE falls to ~16x at ~2850 which means that at that level, stocks on average should continue holding up well. If there is no recession seen next year, and an earnings estimate of $178 for the S&P isn't thought of as a peak number, the multiple can easily squeeze from the current ~16x up towards 17x which would get the index up past 3K and provide a return of over 7% plus dividends. Not bad at all….

We remain mindful of the geopolitical landscape though. While worst-case trade fears are very unlikely to be realized, there are still large frictions between Washington and Beijing to resolve in the coming weeks and months therefore investors need to anticipate some volatility.

We are trying to focus on the intermediate-term opportunity rather than near-term risk.

At various meetings and presentations, we have stated that the direction of the market will follow the direction of earnings, and that direction is up. Year-to-date, the Heward Global Leaders Fund has performed reasonably well with the fund up 9.85% over 1 year. The key drivers have been our investments in global financials, technology and industrials. The "Trump effect" on trade threats and tariffs has impacted a few of our holdings (Porsche being an example). We are constructive that saner minds will prevail, lifting prices into the latter part of 2018 – the US mid-term elections should be a catalyst for some form of resolution – we hope!



Source: FactSet Information Systems

However, while each short-term correction feels like the fundamental background is at risk, we continue to focus on the positive influences that drive our positive outlook and investment thesis; They include: 1) solid and growing global growth; 2) increasing earnings and corporate revenues 3) capital spending is beginning to increase therefore the spin-over effect on "main street" will be felt 4) household incomes are beginning to increase with strong employment and 5) the millennial generation and the demographic push to quality living and higher home ownership (one of our core long term themes).

We highlight 5 of our top holdings with a brief summary and review from the last quarter.

APPLE

Apple is one of our largest holdings and is a core long term investment. Apple's Q3 results were solid. iPhones unit sales were in-line, but ASPs were notably better, leading to a revenue and EPS beat. Services accounted for 18% of Apple revenue in the June-18 quarter, growing 31% y/y. The primary drivers of services revenue include growth of subscriptions (Apple Music, Apple Care, iCloud, etc.) and Apple Pay. Apple has traded at an average forward P/E of 13x since 2010 with a range of 9x to 16x. We believe shares should trade in line with the market multiple given the strong and dominant position the company has in its business. As Warren Buffet stated, Apple is really a consumer product company wrapped in a technology sector.

Why should Proctor & Gamble trade at 19x earnings (and have a low growth rate and declining gross margins) while Apple trades at 14-15x? Apple also has almost 25% of its market capitalization in cash. Apple continues to return money to shareholders in the form of dividends and has repurchased $20b of its shares in the quarter.

HEWARD
INVESTMENT MANAGEMENT INC.

BP

After years of cost-cutting and financial restructuring when crude prices slumped, BP and other big oil companies are benefiting from a recovery in the market. Oil prices are up more than 10% since the start of the year, leading to higher profit and cash flow for producers. Brent crude prices averaged nearly $75 a barrel from April to June, compared with an average of roughly $50 a barrel in the same three months last year. BP's production in the first half rose 3% from a year earlier, delivering on a strategy to return to its former size by the early 2020s. The company announced a $10.5 billion deal to acquire some of the hottest assets in U.S. shale country from BHP Billiton and the acquisition marked BP's biggest in nearly 20 years and signaled the company's growing confidence. At the same time, it said it would increase its dividend for the second quarter. BP trades on 5.7x 2019E debt adjusted cash flow multiple versus the global average at 6.4x, Shell at 6.7x and Total at 5.8x (all fund holdings). The company has a yield of 5.6% which also compares with the other major oil companies.

COCA-COLA

Coke's underlying business trends are positive. Worldwide comparable sales rose 5% year/year in the second quarter and the company slightly raised its forecast for the full year, saying it now sees "at least 4%" comparable revenue growth, up from just "approximately 4%" earlier. KO remains well positioned to deliver solid topline growth over the long-term. Despite near-term foreign exchange headwinds, we like KO's goal to achieve the upper end of its revenue growth target of 4-6% by 2020 given; 1) Strong industry fundamentals, 2) Improving emerging market growth 3) "Premiumization" of flavored products which appeals to millennials, and 4) encouraging early signs from its new Diet Coke relaunch. Importantly, KO has significant runway in key geographies such as India & China given low per-capita soft-drink consumption. We also like the fact that the stock is growing its dividend and the valuation is at the lower end of its historical range. From a valuation perspective, Coke has guidance for the long term of 4-6% organic sales with profit growth of 6-8%. If they achieved these results it would place the company as a top=tier consumer staples company and would likely see its equity valuation reach a higher valuation, particularly given the rest of the consumer group is seeing top line and margin pressure.

JOHNSON & JOHNSON

A new position for the fund is Johnson & Johnson (J&J). It is one of the largest and most diversified healthcare companies in the world, providing a broad range of products across the healthcare spectrum. J&J operates as a holding company with over 260 operating companies around the world. The company's operations are grouped into three segments 1) Pharmaceuticals 2) Medical Devices & Diagnostics 3) Consumer. J&J's division composition has been evolving over the last 5-6 years with Pharma growing in relative size, while Medical Devices and Consumer have shrank. Emerging markets are a significant source of growth for J&J. ~135 million babies are born every year and 75% of them are in emerging markets, where health and sanitation are increasingly important. J&J expects more than 60% of consumer growth to come from emerging markets going forward.

Last quarter, strong sales of Johnson & Johnson's cancer and other drugs helped increase the company's revenue and earnings for the latest quarter, but the US consumer business continued to struggle. Sales in the pharmaceuticals unit rose 20% globally, while cancer-drug sales rose 42%, helped by big gains for its prostate-cancer drug and also a drug that treats a blood-cancer. We estimate that the company will continue to see good earnings and revenue growth over the next several years.

SONY

Sony Corp. reported another strong quarter of earnings, helped by higher sales of electronics hardware, strength in its PlayStation videogame business and demand for smartphone camera components. For the April-June period, the company reported net profit of ¥226.4 billion ($2.04 billion) on ¥1.95 trillion ($17.55 billion) in revenue, compared with net profit of ¥80.9 billion on ¥1.86 trillion in revenue in the same quarter last year. Sony's fiscal first-quarter earnings were also lifted by the sale of part of its stake in Spotify Technology SA. Its operating profit rose to ¥195 billion from ¥157.6 billion a year earlier. The stock is not really well understood by the market. In the quarter, operating profit was up 61% YoY, excluding one-time gains, 30% above the consensus estimate. Growth was solid in the streaming music and game network businesses; the image sensor business and game software sales. Based on company and analyst's reviews, we see substantial upside for the full-year forecast coming from semiconductors and music businesses. Sony pictures is also having a great year.

The stock is cheap, trading at only 12.5x earnings and the free cash flow generation is huge. Our investment thesis is based on mid- long-term earnings growth driven by the game, music, picture and semiconductor businesses. We like the strengthened product offering and their focus on higher margin businesses. The stock is a core holding and we see 25-30% upside.

Geoff Heward & Devon Prangley, CFA
Portfolio Manager & Associate Portfolio Manger
The Heward Global Leaders Fund
gheward@heward.com
Office Direct Geoff Heward: 514-788-0512