

Which Stocks Have High Barriers to Entry?

February 2014 Client Letter

On the back of over \$1 trillion of virtual money-printing by the Federal Reserve, 2013 was a barnburner of a year for most U.S. stocks. Leading the way in the S&P 500 index was the consumer discretionary sector, with a 43% gain. Portfolios not packed with companies including Netflix, Best Buy, GameStop, TripAdvisor,



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and Priceline.com (the top-performing discretionary stocks) probably did not keep pace with the broader market.

Consumer discretionary companies are ones we tend to avoid. The fact the sector had a stellar year does not change our view. Why? At Richard C. Young & Co., Ltd. we favor companies operating in high-barrier-to-entry businesses. We favor companies with durable competitive advantages and ones owning vast reserves of essential natural resources. We favor companies that have built solid brands over decades, giving them pricing power and the ability to withstand threats from competition. Above



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all, we favor dividend-paying stocks with a history of annual dividend increases.

Go back and read the five stocks listed in the first paragraph and ponder this question. If the stock market closed tomorrow and didn't reopen for another five years, would you be comfortable holding stocks from any one of those companies? There isn't a blue-chip in the bunch. I can't even tell you if Netflix, Best Buy, GameStop, or TripAdvisor will be around in five years.

Among the legion of stocks comprising the consumer discretionary sector, few meet our criteria of paying meaningful dividends and operating in high-barrier-



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to-entry industries. High-dividend, high-barrier-to-entry businesses tend to be concentrated in the defensive sectors of the market. To help you better discern the types of characteristics we look for in an investment, I've profiled several of our common stock holdings.

Norfolk Southern

Norfolk Southern (NSC) is a company I am confident will still be a thriving business in five years. When you buy shares of Norfolk Southern, you are making an investment in a durable business operating in a high-barrier-to-entry industry.

The short-term case for



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the continent. NSC has more short-line partners than any other Class I railroad, giving it access to an additional 41,000 miles of track in the Eastern U.S. And, to service fast-growing intermodal transport demands, NSC runs 51 intermodal terminals in the U.S. and Canada.

There are only a few superior rail transportation companies in North America, and chances are there won't be any more. New competition is almost unheard of. The rights of way of North America's railroads were established long ago in a different time unlikely to be duplicated. Norfolk Southern has paid a dividend every year since 1901.



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Orkla

Founded over 350 years ago, Orkla is one of Norway's oldest business conglomerates. Today Orkla is in the process of shedding its conglomerate structure in favor of a more focused strategy. Orkla's new strategy is to become a pure branded-consumer-products company with a concentration in the Nordics. The new strategy has appeal. With a portfolio of well-known brands holding primarily No. 1 and No. 2 positions in the Nordic region, Orkla is already one of the region's premier branded-consumer-goods companies. A more intense focus on branded consumer goods should



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help strengthen the business and improve profitability.

As Orkla continues to transition from a diversified conglomerate to a branded-consumer-goods company that looks more like a regional version of P&G or Clorox, we see opportunity for meaningful improvement in the stock's valuation. We also see opportunity for significant profit margin expansion within the consumer goods division. If Orkla's management is able to achieve margins similar to those of P&G and Unilever, earnings could rise by 70%. Orkla shares yield over 5%.



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Pembina

Pembina is one of Canada's largest pipeline companies. Pembina transports about half of Alberta's conventional crude oil and 30% of western Canada's natural gas liquids. Pembina's business units include conventional pipelines, oil sands and heavy oil, gas services, and midstream.

At Richard C. Young & Co., Ltd., pipelines have long been one of our favored businesses. The pipeline business is simple, the barriers to entry are high, the cash flows are stable and often inflation-adjusted, and the maintenance and operating expenses are minimal.

Pembina shares yield 4.5%



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and offer the prospect of future dividend increases. Pembina shares also have appeal as a pipeline investment in tax-deferred accounts. Most of the pure-play U.S. pipeline companies are structured as master limited partnerships (MLPs). MLPs shouldn't be owned in tax-deferred accounts. Since Pembina is a Canadian C-corp, the shares should be able to be purchased in tax-deferred accounts without incurring adverse tax consequences.

Mosaic

Did you know that according to The Fertilizer Institute, fertilizers are responsible for between 40% and 60% of the world's food supply?



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Without a steady supply of phosphorus, a good portion of the world would face the threat of starvation.

Mosaic is the world's number-one producer of phosphate and the fourth-largest producer of potash in the world. Mosaic's phosphate business accounts for about 10% of global phosphate production. Phosphorous is an essential nutrient that is required for all life. There are no substitutes for phosphorus. It is most widely used in agriculture.

Unfortunately, almost three-quarters of the world's identified phosphorus reserves lay in a disputed territory under the Bou Craa mine in the Western Sahara, a region rife with political unrest



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and terrorism. What is most troubling about the Bou Craa mine is that the phosphate rock produced at the mine must travel down the world's longest conveyor belt (93 miles in total) to the port of El Ayoun before it can be shipped around the world to make fertilizer. The belt is vulnerable to attack and has been attacked in the past by rebels seeking to force Morocco's monarchy from the territory. A major disruption in the supply of phosphate rock coming out of Bou Craa would likely cause phosphate prices to soar. Mosaic would be a big beneficiary in such a scenario, as it sources phosphate rock from its own mines in Florida.

Like phosphate, there are



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no substitutes for potassium as an essential plant nutrient and a vital nutritional requirement for animals and humans. Potassium is critical for plant growth. Mosaic's potash business—potash is the source of potassium—accounts for about 30% of the company's revenues and profits.

The potash industry has historically been controlled by an oligopoly that successfully kept prices high by limiting production. But last July the oligopoly pricing structure started to fall apart as one of the world's largest potash producers, Uralkali, ended a production agreement with Belarusian Potash. Potash



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prices and the stocks of potash producers fell sharply on the news. But with a new CEO recently taking over at Uralkali, the prospects for a new agreement and in turn higher potash prices look promising. Mosaic would be a winner here.

Mosaic may also be a winner as a result of a potential merger. BHP Billiton, one of the world's largest mining companies, is interested in the potash business. BHP made an offer for Potash Corp in 2010 that was blocked by Canadian authorities. BHP has since decided to build its own potash mines, but the high cost of building a new potash mine leaves little profit opportunity for BHP. Instead of moving



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forward with its mine-building strategy, BHP may instead decide to buy its way into the potash business. As one of the world's largest potash producers, Mosaic would be on a short list of candidates.

Southern Company

Of *Fortune Magazine's* "Most Admired Electric and Gas Utilities," Southern Company has scored first place in financial soundness each of the last four years. Southern's service area stretches across the states of Georgia, Alabama, Mississippi, and Florida, where it serves 4.4 million residents. Southern Co. owns 46,000 megawatts of



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electrical generating capacity. Alongside Southern's power business, it is active in telecommunications and wireless communications.

Southern Company's board of directors has chosen to raise the company's dividend in each of the last 12 years. This steady string of dividend increases has allowed Southern to maintain a dividend yield of over 4.9%, even while the price of the company's stock has increased by more than 100% over the same time period.

Quantitative Easing World

If the Federal Reserve
continues to pump



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unnneeded liquidity into the U.S. financial system, a continuation of the speculation-driven rally that characterized much of the last two years may persist in 2014. The Fed has announced that it will taper its bond purchases, but only at a snail's pace and only as long as the economy maintains an upward trajectory.

Despite evidence that quantitative easing (QE) has done little to help the real economy, the Fed remains sanguine about the costs and risks of its policies. As outlined regularly in these letters, we view the costs and risks of QE as unacceptably high. As just one example, in 2012 and 2013 the U.S. stock market rose over



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45%, but corporate profits increased only 11%. The Fed's extended period of ultra-loose monetary policy has fueled a speculative reach for return in the stock market that has markedly increased valuation risk.

The ratio of stock prices to revenues is now about 60% above historic norms. Over the long run, corporate revenues track the 5% growth rate of nominal gross domestic product. If an investor were to buy the S&P 500 index today under the assumption that corporate revenues would compound at 5% for the next five years, but that valuations would revert to their historic norm, he would be facing a loss on the order of 20% (not



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counting dividends). Of course, valuations could remain elevated for an extended period of time, especially in today's QE world, but the historic record argues against such an outcome.

To combat the valuation risk in today's stock market we continue to favor a balanced portfolio featuring individual corporate bonds, foreign currencies and precious metals, and an equity component focused on high-dividend, high-barrier-to-entry businesses.

Have a good month, and as always, please call us at (888) 456-5444 if your financial situation has changed or if you have questions about your



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investment portfolio.

Sincerely,



Matthew A. Young

President and Chief
Executive Officer

P.S. “There is a secular change taking place in that baby boomers who are retiring know they still need to own equities for capital appreciation.... Dividend-paying stocks become very important not just because they generate income but because most are defensive plays, such as consumer staples, utilities and telecommunications, so there’s less risk to



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earnings in an economic slowdown.” Josh Peters, equities strategist for Morningstar®.

P.P.S. A recent Vanguard study shows that of the 1,540 actively managed U.S. domestic equity funds available to investors at the start of 1998, the number of funds that both survived and beat the market was only 18%. And of that small group, 97% lagged their benchmark in at least five of the fifteen calendar years tracked. The message here, of course, is that investors must expect to endure long periods of out-of-favor, poor relative performance. Staying the course is the winning, if difficult, hand. Patience is the name of the game.



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P.P.P.S. According to Steve Forbes, stocks fell at the beginning of the year “because of brewing troubles in emerging markets. And those troubles are the result of economic ignorance: too many central bankers don’t know how to defend their currencies, which are under attack. If they don’t get their act together, we could have another big financial crisis like that which hit in Asia in 1997-98. The danger is that the Fed, the IMF, the European Central Bank, the Bank of England, and the Bank of Japan are just as clueless as their developing country counterparts on how to quickly put a stop to a potentially devastating currency crisis that will hit



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banks hard
everywhere.”



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