Canadian General Investments

Building on positive long-term track record

Investment companies
Canadian equities

8 May 2019

Canadian General Investments' (CGI) manager Greg Eckel is optimistic on the outlook for Canadian equities in 2019, particularly if there is resolution to the US-China trade dispute, along with clarity about the revised North American trade agreement. The manager says that while there are macro issues to consider, the Canadian equity market looks reasonably valued and he is encouraged by the outlook for corporate earnings, judging by the US Q119 results so far. Eckel is continuing to 'stay true to CGI's heritage', following a bottom-up, low portfolio turnover approach, and is finding interesting new investment opportunities. The company has a very strong track record; its NAV has outperformed the S&P/TSX Composite index over the last one, three, five and 10 years. CGI's total dividend is on track for its first growth in seven years, and offers a prospective yield of 3.1%.

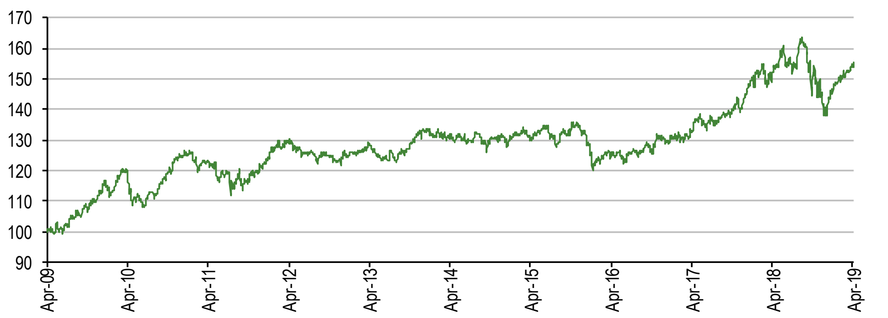
Price	**C$25.71**
Market cap	**C$536m**
AUM	**C$901m**

NAV*	C$35.98
Discount to NAV	28.5%

*Including income. As at 7 May 2019.

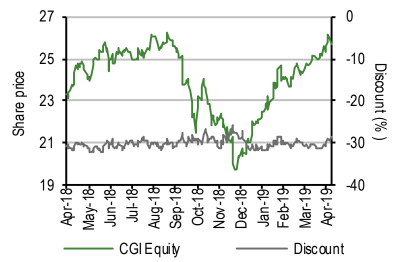
Prospective yield	3.1%
Ordinary shares in issue	20.9m
Code	CGI
Primary exchange	TSE
AIC sector	North America
Benchmark	S&P/TSX Composite

Significant long-term NAV outperformance versus the benchmark

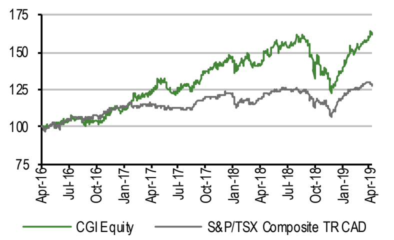


Source: Refinitiv, Edison Investment Research

Share price/discount performance



Three-year performance vs index



52-week high/low	C$26.24	C$19.70
NAV** high/low	C$37.54	C$27.20

**Including income.

Gearing

Gross*	17.1%
Net*	12.5%

*As at 31 March 2019.

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The market opportunity

Investors may not fully appreciate that there are many investment opportunities available in Canada outside of the financial and commodity sectors. In addition, Canadian equities look attractively valued compared with US stocks, which may provide an opportunity for investors seeking North American exposure.

Why consider investing in CGI?

- May be considered as a 'one-stop-shop' for investment in Canada.
- Significant long-term outperformance versus the benchmark.
- Disciplined, bottom-up stock selection approach.
- Growing distribution, with a prospective 3.1% dividend yield.

Wide discount despite strong performance record

Despite its long-term history of outperformance, CGI's shares continue to trade at a wide discount. This may be due to liquidity concerns, given more than 50% of shares are owned by related parties. Its current 28.5% discount to NAV is broadly in line with the 26.6% to 30.1% range of discounts over the last one, three, five and 10 years. CGI has C$150m in preference shares and debt; net gearing at end-March 2019 was 12.5%. The board has increased its first two quarterly dividends in 2019, and the company is currently offering a 3.1% prospective dividend yield.

Exhibit 1: Company at a glance

Investment objective and fund background

CGI's objective is to provide better-than-average returns to shareholders by investing in a diversified portfolio of primarily Canadian equities. It aims to achieve this through prudent security selection, timely recognition of capital gains/losses and appropriate use of income-generating instruments.

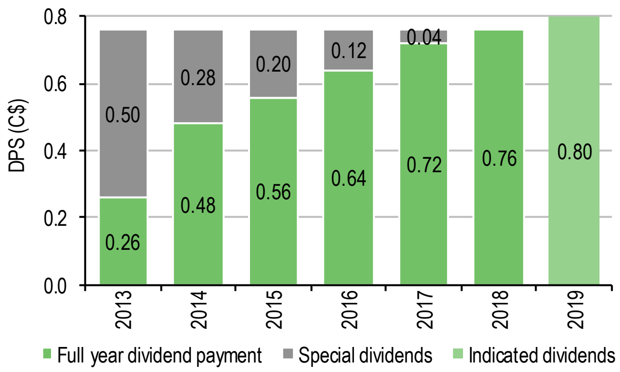
Recent developments

- 11 April 2019: Announcement of quarterly dividends – C$0.20 per common share and C$0.23438 per Series 4 preference share.
- 11 March 2019: Annual report for 12 months ended 31 December 2018. NAV total return of -10.9% versus -8.9% for the S&P/TSX Composite Index. Share price total return -10.8%.
- 21 February 2019: Announcement of quarterly dividends – C$0.20 per common share and C$0.23438 per Series 4 preference share.

Forthcoming		Capital structure		Fund details	
AGM	April 2020	Ongoing charges	1.48% (see MER below)	Group	Morgan Meighen & Associates
Interim results	August 2019	Net gearing	12.5%	CEO	Jonathan A Morgan
Year end	31 December	Annual mgmt fee	1.0% (see page 8)	Address	10 Toronto Street, Toronto, Ontario, Canada M5C 2B7
Dividend paid	Mar, Jun, Sep, Dec	Performance fee	None		
Launch date	January 1930	Company life	Indefinite	Phone	+1 416 366 2931
Continuation vote	No	Loan facilities	C$150m (see page 8)	Website	www.mmainvestments.com

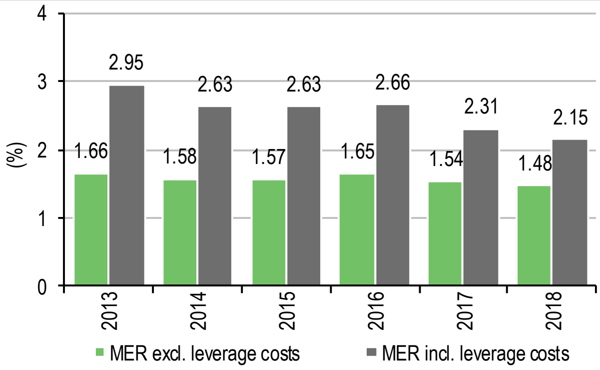
Dividend policy and history (financial years)

CGI revised its dividend policy in 2014, intending to pay steady to rising quarterly dividends with less emphasis on the special final dividend. The two quarterly dividends announced so far in FY19 are 5.3% higher year-on-year.

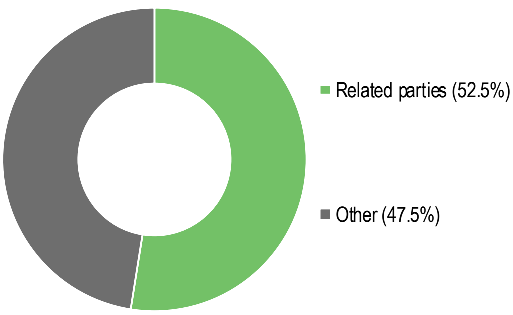


Management expense ratio (MER)

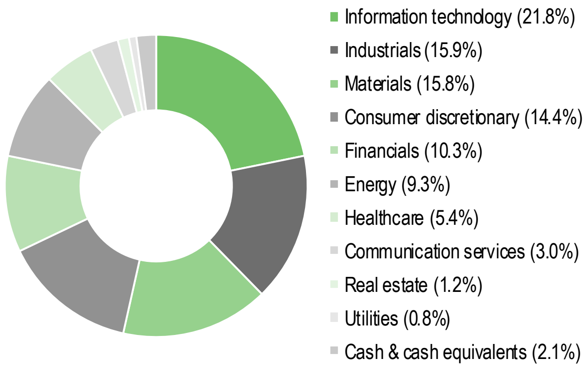
CGI pays a monthly management fee at 1.0% per year of gross assets. Leverage costs include preference share dividends, interest and financing charges.



Shareholder base (as at 30 April 2019)



Portfolio exposure by sector (as at 30 April 2019)



Top 10 holdings (as at 30 April 2019)

			Portfolio weight %	
Company	**Country**	**Sector**	**30 April 2019**	**30 April 2018***
Shopify	Canada	Internet services	6.2	3.7
Mastercard	US	Financial transaction processing	3.9	N/A
Canadian Pacific Railway	Canada	Railroads	3.8	3.2
Air Canada	Canada	Airlines	3.7	3.4
Amazon.com	US	Online retail	3.2	4.1
Bank of Montreal	Canada	Banks	3.2	3.2
Canopy Growth	Canada	Cannabis production	3.1	N/A
Franco-Nevada Corp	Canada	Gold mining	3.0	3.4
Royal Bank of Canada	Canada	Banks	2.9	N/A
First Quantum Minerals	Canada	Copper mining	2.8	3.9
Top 10 (% of holdings)			**35.8**	**36.6**

Source: Canadian General Investments, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-April 2018 top 10.

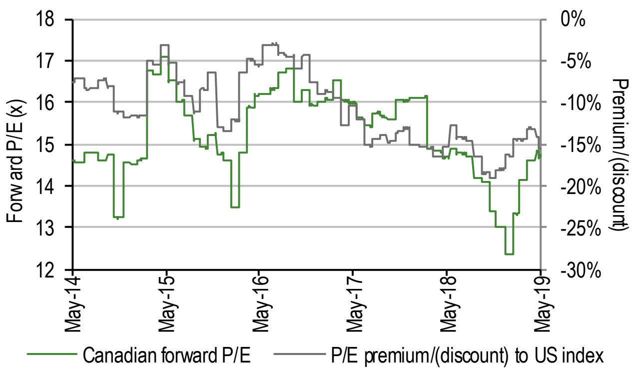
Market outlook: Canadian equity valuations attractive

Q418 proved to be a particularly tough time for global markets, including Canada. To provide some context, in December last year the major US indices suffered their worst monthly declines since February 2009, and the worst December performances since 1931. For the year as a whole, the Canadian market delivered a -8.9% total return in local currency terms, with only the technology, consumer staples and real estate sectors generating positive returns (Exhibit 2, RHS). This year has seen a reversal in fortunes as global investors are more hopeful about a resolution to the US-China trade dispute, and the US Federal Reserve has adopted a more dovish stance. Focusing on Canada, as shown in the table below, in Q119 stocks more than made up for losses incurred last year, delivering a +13.3% total return, with all 11 sectors in positive territory. While investors may associate Canada mainly with financial and commodity companies, the country offers broader exposure than may be widely understood – c 50% of constituents and c 40% of the S&P/TSX Composite index exposure are outside of the financials, energy and materials sectors.

Canadian stocks continue to look relatively attractively valued. As measured by Datastream indices, they are currently trading on a 14.7x forward P/E multiple (Exhibit 2, LHS). This is a 15.6% discount to the US market, which is considerably wider than the 10.8% average discount over the last five years. Investors seeking North American exposure may benefit from casting their net wider than the US; there is a wide selection of investment opportunities available in Canada, a market that is on aggregate trading on a relatively attractive forward P/E valuation.

Exhibit 2: Valuation and S&P/TSX Composite index data

Valuation of DS Canada index versus DS US index



S&P/TSX Composite index data (as at 31 March 2019)

	Number of companies	Weight (%)	Q119 total return (%)	2018 total return (%)
Financials	26	31.7	10.4	(9.3)
Energy	41	18.0	15.6	(18.3)
Materials	49	11.2	8.5	(9.3)
Industrials	30	10.9	15.3	(2.4)
Comm'n services	7	5.8	10.0	(0.8)
Information tech.	10	4.5	25.3	13.0
Utilities	16	4.2	16.1	(8.9)
Cons. discretionary	17	4.1	9.8	(16.0)
Consumer staples	10	3.9	10.6	2.0
Real estate	25	3.5	17.5	2.0
Healthcare	11	2.2	49.1	(15.9)
Index	242	100.0	13.3	(8.9)

Source: Refinitiv, Bloomberg, Edison Investment Research. Note: Performance in Canadian dollar terms.

Fund profile: Well-established Canadian specialist

CGI is North America's second-oldest, closed-end equity fund, established in 1930. It is listed on the Toronto Stock Exchange (since 1962) and the London Stock Exchange (since 1995). Since 1956, the company has been managed by Morgan Meighen & Associates (MMA), a Canadian investment firm with c C$1.8bn of assets under management. The lead manager (since 2009) is Greg Eckel, who invests in Canadian and selected US companies (up to 25% of the fund) with a medium- to long-term horizon. He aims to generate a better-than-average total return from a diversified portfolio, via prudent stock selection and timely recognition of capital gains and losses. Eckel's unconstrained investment approach means that CGI's sector weightings can differ markedly from the benchmark S&P/TSX Composite index. The fund is designated as an investment corporation under the Income Tax Act (Canada), which eliminates a layer of taxation, as capital gains are only taxed at the shareholder level, allowing capital gains to be paid as dividends to shareholders. To maintain this favourable tax status, CGI is unable to repurchase its shares to help manage the share price discount to NAV. No more than 25% of its gross revenue may be from interest income, and at least 85% of gross revenue must be from Canadian sources. The company has employed a leveraged strategy since its first issue of preference shares in 1998. Gearing of C$150m is made up of C$75m Series 4, 3.75% preference shares and C$75m bank debt; at end March 2019, net gearing was 12.5%.

The fund manager: D Greg Eckel

The manager's view: Cautiously constructive on the outlook

The manager says that along with the rest of the world, economic growth in Canada is moderating, although a bit of a revival in the oil sector may offset some of the slowdown. He believes that if outstanding trade disputes were resolved, it would undoubtedly help the global economy. Eckel is encouraged by the continued pace of economic growth in the US, given it is Canada's largest trading partner. In addition, the Bank of Canada (like the US Federal Reserve) has adopted a more dovish approach, which should be supportive of growth. The change in stance is in response to US-China trade tensions, a lack of clarity on the new North American agreement to replace NAFTA, and the slowing domestic economy.

While there have been recommendations by some US-based analysts to sell out of Canadian banks, Eckel is unconvinced. He says that he has heard this argument before and if he had taken heed, it would have been detrimental to CGI's performance. While the fund is underweight banks, as the manager is finding better investment opportunities elsewhere, it maintains some exposure to the group. Eckel notes that Canada 'sailed through the global financial crisis' with its economy relatively unaffected, unlike many other countries, and the credit cycle in Canada looks relatively benign, with low levels of delinquencies and consumers having high levels of disposable income compared with their levels of debt.

Commenting on global stock markets, the manager says that share price appreciation year to date 'is remarkable, and a complete opposite to Q418'. He notes that in the Canadian market, stock leadership has been broad, which is positive for CGI's diversified portfolio. In Q119, the healthcare sector was particularly strong, led by cannabis stocks, while materials and consumer discretionary were the worst-performing sectors.

Asset allocation

Investment process: Long-term investment approach

Seeking to generate a better-than-average total return, manager Eckel selects stocks on a bottom-up basis, while taking account of the broad investment backdrop. He is able to draw on the expertise of MMA's seven other investment professionals, seeking companies with strong fundamentals, respected management teams, and which are trading on reasonable valuations. The manager's long-term approach means that many of CGI's positions have multi-year holding periods, although they are regularly reassessed to ensure that they are sized correctly and that the investment case still holds true. Portfolio turnover was particularly low at 2.3% in 2018; over the last five years it has ranged between 2.3% and 21.5% (average of 12.7%).

Eckel has a history of successively backing good management teams, who may change employers as a result of mergers and acquisitions. The majority of the fund is invested in Canadian equities; however, up to 25% may be invested in US companies in order to gain exposure to niche operations or business areas that are unavailable for investment in Canada (c 18% at end-March 2019). US holdings include top 10 positions in Mastercard and Amazon.com. Some of CGI's positions are higher-yielding, such as the Canadian banks, which help to support CGI's dividend payments. The manager has a bias to mid- and large- cap stocks; the median market cap is c C$8bn and more than 95% of the portfolio (by value) has a market cap above C$1bn.

Current portfolio positioning

At end-April 2019, CGI's top 10 positions made up 35.8% of the portfolio, which was not dissimilar to 36.6% a year earlier; seven positions were common to both periods. CGI's sector exposure is shown in Exhibit 3. Its largest weighting is technology (c 22% versus the maximum permitted 35% in a single sector), while the largest active weights are financials (-22.2pp, primarily banks) and technology (+17.2pp). The manager has been consistently underweight energy stocks since 2011, which has been the right call; for example, in 2018, the sector delivered the worst total return in the S&P/TSX Composite (-18.3% versus -8.9% for the index). Over the last 12 months to the end of April 2019, the largest sector increase has been in technology (+7.9pp), with the biggest decrease in materials (-5.1pp).

Exhibit 3: Portfolio sector exposure vs benchmark (% unless stated)

	Portfolio end April 2019	Portfolio end April 2018	Change (pp)	Index weight	Active weight vs index (pp)	Fund weight/ index weight (x)
Information technology	21.8	13.9	7.9	4.6	17.2	4.7
Industrials	15.9	13.6	2.3	11.1	4.8	1.4
Materials	15.8	20.9	(5.1)	10.2	5.7	1.6
Consumer discretionary	14.4	17.2	(2.8)	4.3	10.1	3.4
Financials	10.3	13.3	(3.0)	32.5	(22.2)	0.3
Energy	9.3	12.6	(3.3)	18.3	(9.0)	0.5
Healthcare	5.4	2.3	3.1	2.2	3.2	2.5
Communication services	3.0	3.0	0.0	5.6	(2.6)	0.5
Real estate	1.2	1.2	0.0	3.3	(2.1)	0.4
Utilities	0.8	0.7	0.1	4.1	(3.3)	0.2
Consumer staples	0.0	0.7	(0.7)	3.8	(3.8)	0.0
Cash & cash equivalents	2.1	0.6	1.5	0.0	2.1	N/A
	100.0	**100.0**		**100.0**		

Source: Canadian General Investments, Edison Investment Research

Eckel comments that the broad stock market sell-off in Q418 was a result of macro events and a change in investor sentiment; as such he did not feel the need to change the shape of CGI's portfolio, and this strategy has proved beneficial to the company's performance in 2019. The manager highlights a few of the fund's newer positions:

- **Aurora Cannabis** – adding to exposure to the cannabis sector (CGI now holds three firms in the group). Eckel says Aurora has scale, including international operations, and its share price has lagged the rest of the group, although the gap has started to narrow. So far, the company has not entered into a major partnership; peers that have done so have experienced meaningful share price appreciation. The manager explains that a partnership is an increasing possibility following the company's involvement with US activist investor Nelson Peltz.
- **Lightspeed POS** – this was a March 2019 initial public offering (IPO). It was the largest technology IPO in Canada for nearly nine years, and was well received, with its stock price appreciating by c 20% on its first day of trading. Lightspeed's share price has continued to move higher, and at the time of writing it is c 50% higher than the C$16 per share IPO price. Lightspeed is a cloud-based software company with a high percentage of recurring revenues and a low share of its total addressable market. Eckel believes the company has a 'game-changing' product offering, including point-of-sale and e-commerce solutions for retailers and restaurateurs to manage their businesses. Given the majority of shares are tightly held, CGI received a modest allocation in the IPO and has been buying shares in the secondary market. The manager believes that Lightspeed has good potential, referring to it as 'Shopify number two' in reference to another of the fund's very successful investments (now the largest holding in the portfolio).
- **Waste Connections** – the third-largest waste management company in North America. The manager says the firm is generating steady growth both organically and via acquisitions, along

with significant amounts of free cash flow. Waste Connections has a vertically integrated business model, operating in second- and third-tier cities, which tend to be less competitive than primary markets.

Performance: Very long-term record of outperformance

Exhibit 4: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	S&P/TSX Composite (%)	MSCI Canada (%)	FTSE World (%)
30/04/15	15.3	6.6	6.9	8.5	18.6
30/04/16	(9.0)	(9.0)	(5.4)	(6.6)	(0.9)
30/04/17	21.6	21.8	14.9	15.7	26.3
30/04/18	16.7	17.6	3.1	3.7	7.3
30/04/19	13.1	12.1	9.6	9.7	10.9

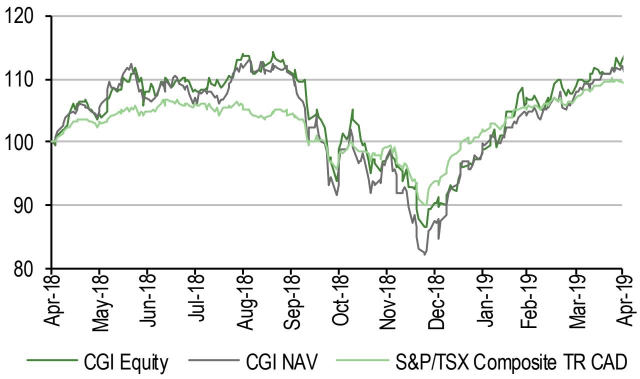
Source: Refinitiv. Note: All % on a total return basis in Canadian dollars.

CGI has enjoyed a very long-term record of outperformance versus the S&P/TSX Composite index. Data from MMA show that in the 25 years to the end of 2018, the company generated total returns of 9.0% pa (+1.6pp higher than the benchmark's +7.4% pa total return), while over the last 50 years the outperformance is even greater (+1.8pp) at +10.5% pa versus +8.7% pa for the index.

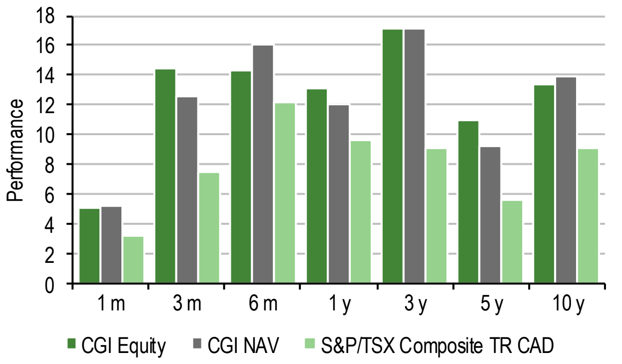
In 2018, CGI's local currency NAV and share price total returns of -10.9% and -10.8% lagged the -8.9% total return of the benchmark. Performance was helped by having its largest overweight exposure in technology, which was the top-performing sector last year; global e-commerce platform Shopify was a standout performer, delivering a total return of c 50%. Other positive contributors included apparel company Canada Goose and US online retailer Amazon.com. Holdings detracting from performance in 2018 included retailer and long-standing outperformer Dollarama (held since the company first listed in 2009), as it failed to meet its usual high earnings expectations. Base metal stocks were also weak on fears about slowing global growth, which negatively affected CGI's holdings including First Quantum Minerals, Hudbay Minerals and Lundin Mining.

Exhibit 5: Investment company performance to 30 April 2019 (Canadian dollar terms)

Price, NAV and benchmark total return performance, one-year rebased



Price, NAV and benchmark total return performance (%)



Source: Refinitiv, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

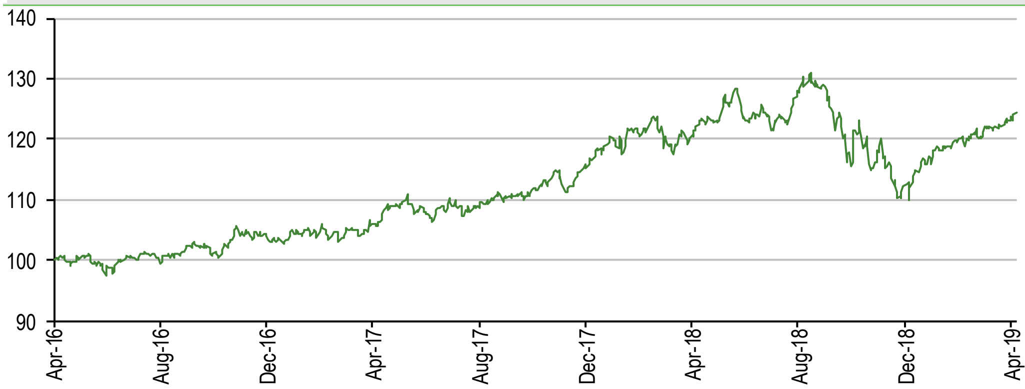
The fund's relative performance across a variety of time periods is shown in Exhibit 6. Its NAV has modestly outperformed over the last year, but has meaningfully exceeded the benchmark's total returns over three, five and 10 years. As shown Exhibit 7, so far in 2019, having undergone a tough period of performance in H218, CGI is continuing to build on its positive long-term record. The manager says this has come from a variety of sources, including Shopify, cannabis stocks Canopy Growth and Aurora Cannabis, and commodity stocks First Quantum, Hudbay Minerals and Parex Resources. When we met with Eckel on 24 April 2019, he noted that CGI owned five of the top 10 year to date performers in the S&P/TSX Composite index.

Exhibit 6: Share price and NAV total return performance, relative to indices (%)

	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to S&P/TSX Composite	1.8	6.4	2.0	3.2	23.6	28.3	47.2
NAV relative to S&P/TSX Composite	2.0	4.6	3.5	2.3	23.6	18.6	54.8
Price relative to MSCI Canada	1.2	6.0	1.8	3.1	22.0	26.3	52.8
NAV relative to MSCI Canada	1.4	4.2	3.3	2.2	22.0	16.8	60.6
Price relative to FTSE World	0.8	3.8	2.4	2.0	6.8	(4.6)	1.4
NAV relative to FTSE World	1.0	2.1	3.9	1.0	6.9	(11.7)	6.6

Source: Refinitiv, Edison Investment Research. Note: Data to end-April 2019 in C$ terms. Geometric calculation.

Exhibit 7: NAV total return performance relative to benchmark over three years



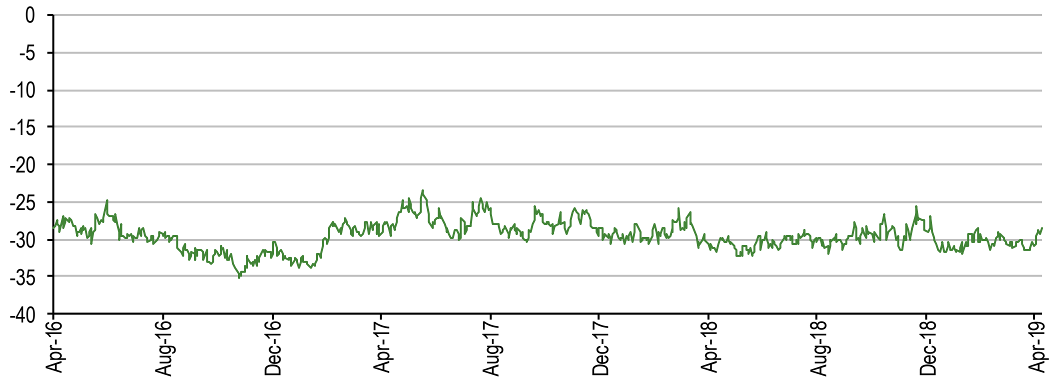
Source: Refinitiv, Edison Investment Research

Discount: Broadly in line with historical averages

The company consistently trades at a wide discount to NAV despite its long-term history of outperformance. This may be due to the high level of insider ownership (52.5%), affecting investor perceptions regarding liquidity, although the structure does ensure that the interests of management and shareholders are aligned. It is also interesting to note that over the last 20 years, there have been brief periods when the company traded at a premium (the last time was in 2006).

CGI's shares are currently trading at a 28.5% discount to NAV, which is broadly in line with the averages of the last one, three, five and 10 years (30.1%, 29.6%, 28.8% and 26.6% respectively). The board is unable to repurchase any of CGI's shares to help manage the discount, as this would invalidate its favourable Canadian investment corporation tax status.

Exhibit 8: Share price discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

Capital structure and fees

CGI has 20.9m ordinary shares in issue and gearing of C$150m (C$75m Series 4, 3.75% preference shares, redeemable on or after 15 June 2023, and a C$75m, 2.28% fixed-rate, three-year, non-revolving bank credit facility – a combined 3.015% cost of capital). The credit facility expires on 6 June 2019; the board is looking into other facilities, but given the current low level of interest rates, it is likely that the loan will be rolled over. At end-March 2019, taking 4.6% in cash and equivalents into account, net gearing was 12.5%.

MMA is paid an annual management fee of 1.0% of the market value of its investments, net of cash, portfolio accounts receivable and portfolio accounts payable (no performance fee is payable). In 2018, the annualised management expense ratio (MER) was 2.15% including leverage costs (16bp lower than 2.31% in 2017, and 51bp lower than 2.66% in 2016). The MER excluding leverage costs is more comparable with the ongoing charge figure used in the UK; in 2018, it was 1.48%, which was 6bp lower year-on-year.

Dividend policy and record

In 2018, CGI received dividend income of C$15.6m, which was 22.2% higher than C$12.7m in 2017, helped by a C$2.1m special dividend from building products company Norbord.

Since 2014, there has been an increased emphasis on quarterly dividends, and less on special dividends. In 2018, four quarterly dividends of C$0.19 were paid (with no specials), which equates to a yield of 3.0%. So far in 2019, two quarterly payments of C$0.20 have been declared (+5.3% year-on-year, and the manager is hopeful of further dividend increases in the future); if this distribution level is maintained for the balance of the year, the C$0.80 total dividend would equate to a prospective 3.1% yield. It should be noted that prior to 2019, the total distribution was maintained at C$0.76 pa for six years, although the balance between regular and special dividends shifted significantly during this time.

Peer group comparison

CGI is one of the two funds in the AIC North America sector with significant Canadian exposure (Exhibit 9). While a comparison between the two funds has some relevance, it should be noted that they have different investment mandates. CGI has significantly better NAV total return performance over one, three and five years, while lagging over 10 years. Despite its long-term record of outperformance, the company consistently trades at a wide discount, which may be due to its high inside ownership. Both of the funds have a similar level of net gearing. CGI has a lower dividend yield, which is unsurprising given its focus on total return rather than income.

Exhibit 9: Selected peer group as at 3 May 2019 (C$)*

% unless stated	Market cap	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Canadian General Investments	542.4	11.2	62.9	52.5	258.9	(29.5)	1.5	No	113	3.0
Middlefield Canadian Income	179.7	7.8	27.1	22.3	298.4	(12.0)	1.3	No	112	5.3
Average	**361.0**	**9.5**	**45.0**	**37.4**	**278.7**	**(20.7)**	**1.4**		**112**	**4.2**
Fund rank in sector	**1**	**1**	**1**	**1**	**2**	**2**	**1**		**1**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 2 May 2019 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

The board

CGI's board comprises seven directors, four of whom are independent of the investment manager. The three non-independent board members are: Vanessa Morgan (chairman of CGI, president and CEO of MMA – appointed to the board in 1997); Jonathan Morgan (president and CEO of CGI, executive vice-president of MMA – appointed to the board in 2001); and Michael Smedley (executive vice president and CIO of MMA – appointed to the board in 1989). The four independent directors and their years of appointment are: Neil Raymond (2002), Richard Whittall (2004), James Billett (2005) and Michelle Lally (2015). The average tenure of the seven directors is c 17 years.

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