Canadian General Investments

Continuing to find interesting investment ideas

Investment companies
North American equities

7 November 2019

Price	**C$23.91**
Market cap	**C$499m**
AUM	**C$913m**

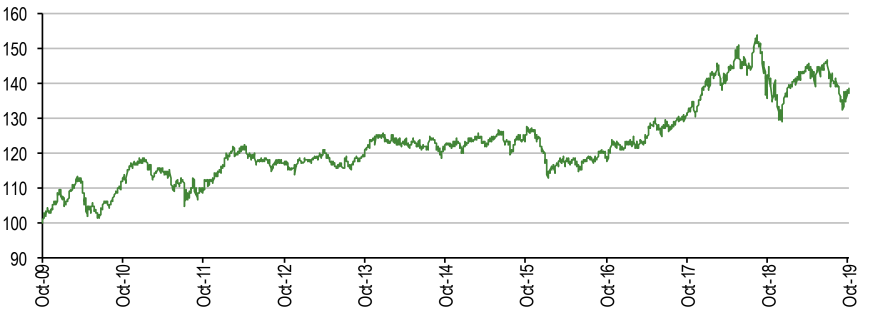
NAV*	C$35.36
Discount to NAV	32.4%

*Including income. As at 5 November 2019.

Yield	3.3%
Ordinary shares in issue	20.9m
Code	CGI
Primary exchange	TSX
AIC sector	North America
Benchmark	S&P/TSX Composite

Canadian General Investments (CGI) is a well-established company with a long-term track record of outperformance. Manager Greg Eckel is 'sticking to his knitting', seeking companies with strong fundamentals and well-respected management teams, that are trading on reasonable valuations and can be held for the long term. While there are economic headwinds, including the ongoing US-China trade dispute, the manager says that 'Canada remains an island of stability', and suggests investors may benefit from Canadian exposure as part of a global portfolio. Eckel is continuing to find what he considers to be interesting investment opportunities in a variety of sectors, in both Canada and the US.

CGI has a long-term record of NAV outperformance versus the benchmark



Source: Refinitiv, Edison Investment Research

The market opportunity

The opportunities available from investing in Canada may not be widely appreciated by global investors. Its economic and political backdrop has remained relatively stable, there is a broad range of companies in which to invest (not just in the prominent financial and energy sectors), and equity valuations continue to compare favourably with the neighbouring US market.

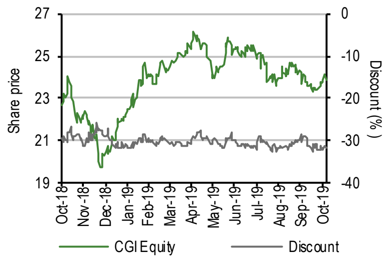
Why consider investing in CGI?

- Diversified exposure to Canadian and selected US equities.
- Unconstrained, fundamental approach to stock selection.
- Medium- and long-term outperformance versus the benchmark S&P/TSX Composite Index.
- Growing dividend and 3.3% yield.

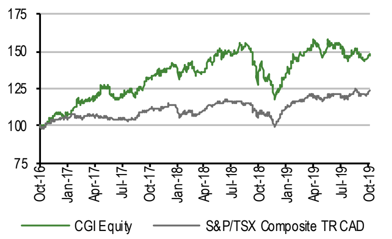
Potential for a narrower discount

While CGI consistently trades at a wide discount, there have been brief periods in the last 20 years when the company traded at a premium (most recently in 2006). The current 32.4% discount to cum-income NAV compares with the 27.1% to 30.3% range of discounts over the last one, three, five and 10 years. Having remained stable for the prior six years, FY19 marks an increase in CGI's annual dividend; the fund now offers a 3.3% yield. The company follows a levered strategy; at end-October 2019, net gearing was 16.2%.

Share price/discount performance



Three-year performance vs index



52-week high/low	C$26.21	C$19.70
NAV* high/low	C$37.20	C$27.20

*Including income.

Gearing

Gross*	19.5%
Net*	16.2%

*As at 31 October 2019.

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Canadian General Investments is a research client of Edison Investment Research Limited

Exhibit 1: Company at a glance

Investment objective and fund background

Canadian General Investments' 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.

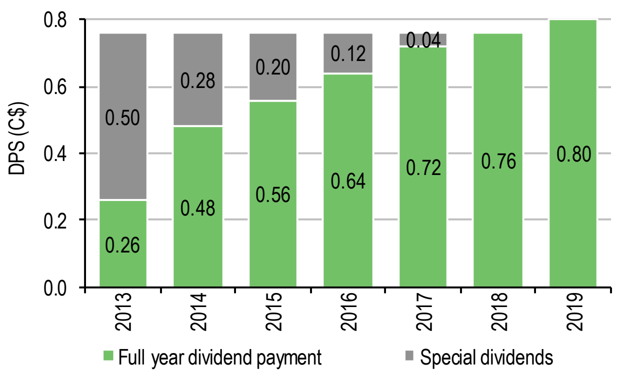
Recent developments

- 16 October 2019: Announcement of quarterly dividends – C$0.20 per common share and C$0.23438 per Series 4 preference share.
- 9 August 2019: Interim report for six months ended 30 June 2019. NAV total return of +26.5% versus +16.2% for the S&P/TSX Composite Index. Share price total return +25.4%.
- 17 July 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	1.56% (see MER below)	Group	Morgan Meighen & Associates
Final results	March 2020	Net gearing	16.3%	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$175m (see page 8)	Website	www.mmainvestments.com

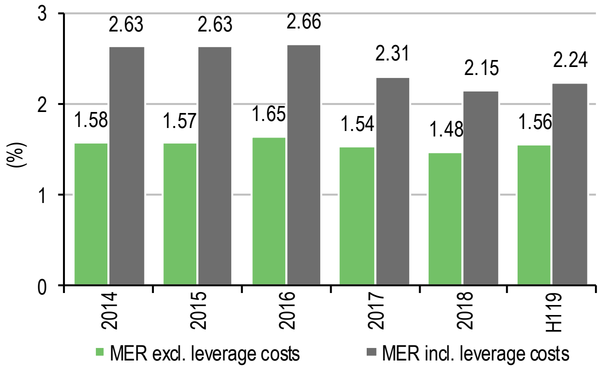
Dividend policy and history (financial years)

CGI revised its dividend policy in 2014, intending to pay steady to rising quarterly dividends with less emphasis on the special final dividend.

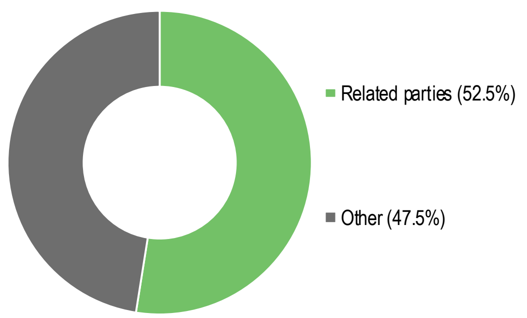


Management expense ratio (MER)

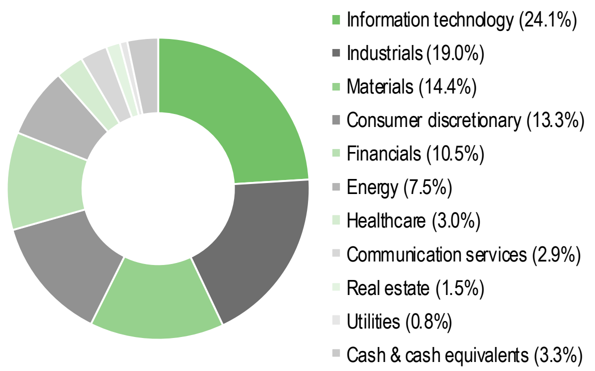
CGI pays a monthly management fee at 1.0% per year of gross assets. Leverage costs include preference share dividends, interest and financing charges.



Shareholder base (as at 31 October 2019)



Portfolio exposure by sector (as at 31 October 2019)



Top 10 holdings (as at 31 October 2019)

			Portfolio weight %	
Company	**Country**	**Sector**	**31 October 2019**	**31 October 2018***
Shopify	Canada	Internet services	6.7	4.1
Air Canada	Canada	Airlines	5.5	3.5
Mastercard	US	Financial transaction processing	4.3	3.3
Franco-Nevada Corp	Canada	Gold mining	4.1	3.2
Canadian Pacific Railway	Canada	Railroads	3.8	3.8
Cash & cash equivalents	N/A	N/A	3.3	N/A
Amazon.com	US	Online retail	3.0	4.5
Bank of Montreal	Canada	Banks	3.0	3.3
Royal Bank of Canada	Canada	Banks	2.9	N/A
NVIDIA Corporation	US	Semiconductors	2.6	4.6
Top 10 (% of holdings)			**39.2**	**37.1**

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

Market outlook: Broad opportunity at a discount to US

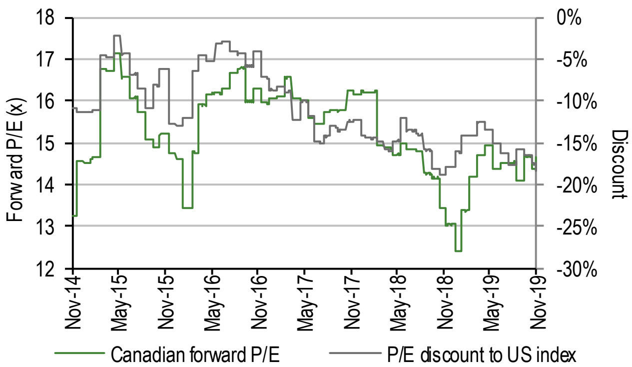
The breakdown of the S&P/TSX Composite Index is shown in Exhibit 2 (LHS). While investors may associate the Canadian market mainly with financial and energy companies, as at end-October 2019, these two sectors made up less than 50% of the index capitalisation, and just 25% of its 233 constituents. Over the first 10 months of this year, Canadian stocks made good headway, with the index generating a total return of c 18%, and all but one of the sectors in positive territory. Following on from its standout performance in 2018 (when most sectors declined in value), this year technology is once again leading the charge, with a c 46% total return to the end of October. Considering valuations (Exhibit 2, RHS), the Datastream Canada index is trading on a forward P/E multiple of 14.7x, which is 18.2% below the US market P/E, a considerably wider discount than the 11.2% five-year average. Investors looking to broaden their developed market equity exposure may find opportunities in a diversified, relatively attractively valued market such as Canada.

Exhibit 2: S&P/TSX Composite Index data and valuation

S&P/TSX Composite Index data (as at 31 October 2019)

	Number of companies	Weight (%)	10M19 total return (%)	2018 total return (%)
Financials	27	33.2	20.7	(9.3)
Energy	32	16.0	8.8	(18.3)
Materials	49	11.3	18.2	(9.3)
Industrials	32	11.1	20.4	(2.4)
Comms services	7	5.5	10.3	(0.8)
Information tech	9	5.1	46.4	13.0
Utilities	16	4.7	33.5	(8.9)
Cons discretionary	16	4.2	13.1	(16.0)
Consumer staples	10	3.9	13.7	2.0
Real estate	25	3.6	22.7	2.0
Healthcare	10	1.3	(9.7)	(15.9)
Index	**233**	**100.0**	**18.1**	**(8.9)**

Valuation of DS Canada index versus DS US index (last five years)



Source: Refinitiv, Bloomberg, Edison Investment Research. Note: Performance in Canadian dollar terms. Numbers subject to rounding.

Fund profile: Very long-term record of outperformance

CGI was established in 1930 and is North America's second-oldest closed-end equity fund. It has been listed on the Toronto Stock Exchange since 1962 and the London Stock Exchange since 1995. Morgan Meighen & Associates (MMA) has managed the company since 1956; it has c C$2bn in assets under management for private and institutional clients and fund investors.

Greg Eckel has been CGI's lead manager since 2009; he aims to generate a better-than-average total return from a diversified portfolio of Canadian (and selected US) equities via prudent stock selection and timely recognition of capital gains and losses. The manager invests with a medium- to long-term view and employs an unconstrained investment approach, meaning the fund's sector weightings may differ significantly from those of the benchmark S&P/TSX Composite Index.

CGI 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. However, to maintain this favourable tax status, the company is unable to repurchase its shares to help manage the share price discount to NAV. A maximum 25% of its gross revenue may come from interest income, and at least 85% of gross revenue must be from Canadian sources.

The fund has a long-term record of outperformance; data from MMA show that over the last 25 years (to end-December 2018) CGI has generated a total return of +9.0% pa, 1.6pp higher than the benchmark's +7.4% pa total return. Over the last 50 years, the total return performance differential is even wider, at 1.8pp (+10.5% for CGI versus +8.7% for the index).

The fund manager: D Greg Eckel

The manager's view: Canadian economy doing 'okay'

Eckel says that while growth is moderating, the Canadian economy is 'muddling along', which he deems to be satisfactory given the global economic slowdown. He suggests that Canadian GDP growth could come in at around 1.9% for 2019, and slightly lower in 2020. The manager says that the energy sector is weighing on economic activity, but by less than in recent quarters. Furthermore, there are pockets of strength, such as in the labour market, while low interest rates are supporting indebted consumers. He comments that prospects for the Canadian housing sector are improving following the end of government incentives aimed at taking air out of the property bubble, noting better pricing and higher home sales. Despite a more strained relationship with China following the arrest of the Huawei CFO, which is affecting Canadian exports to the country, Eckel says that domestic economic growth has been reasonably consistent, suggesting that its resilience (which he expects will continue) has been a surprise to some market participants.

The manager offers his thoughts on the recent Canadian federal election, in which Justin Trudeau's Liberal Party returned to power, but as a minority government. Eckel explains that typically when this happens there is no coalition formed, although there tends to be tolerance, as most parties recognise that the electorate gets irritated with the idea of an early election. One of the important issues to be addressed is the expansion of the Trans Mountain pipeline, which the Liberals are keen to pursue; while the project also has the support of the Conservatives, there has been opposition from other political parties. With regard to the United States-Mexico-Canada Agreement (USMCA, the trade agreement seen as a successor to NAFTA), Mexico has approved the deal, the US is waiting to do so, while the Canadian government has been focusing on the recent general election. Eckel says it is very much 'wait and see', particularly in light of the ongoing trade dispute between the US and China. The manager hopes that if the US and China come to a solution, Canada will not be cut out of a trade deal with China, given the tension between the two countries noted above.

Asset allocation

Investment process: Unconstrained, fundamental approach

Although Eckel is mindful of the macro backdrop, stock selection is primarily the result of bottom-up fundamental research. He aims to generate an above-average total return from a diversified portfolio of Canadian equities, although up to 25% of the fund may be invested in US equities, primarily in companies whose businesses are niche or under-represented in the Canadian market. At end-October 2019, the asset mix was 76.4% Canada, 20.3% US and 3.3% cash/equivalents.

The manager seeks companies that have strong fundamentals and respected management teams, and that are trading on reasonable valuations. CGI's portfolio turnover is relatively low, reflecting Eckel's long-term investment approach; it was just 2.3% in 2018, versus a five-year average of c 13%. However, it should be noted that despite multi-year holding periods, the portfolio positions are regularly reassessed to ensure that they are sized correctly and that the investment case remains intact. The manager has a history of successively backing good management teams, who may change employers due to mergers and acquisitions. He has a bias to mid and large, rather than small-cap stocks, and some of CGI's positions are higher yielding, such as the Canadian banks, to help support the fund's own dividend payments.

Current portfolio positioning

At end-October 2019, CGI's top 10 positions made up 39.2% of the fund, which was a modest increase in concentration compared with 37.1% a year earlier; eight positions were common to both periods. The fund's sector breakdown is highlighted in Exhibit 3; there have been relatively modest changes over the last 12 months, including a higher weighting in industrials (+4.9pp) and technology (+4.6pp), and a lower exposure to consumer discretionary (-4.3pp). Eckel's unconstrained investment approach is clearly evidenced by CGI's large underweight in financials (-22.7pp), while favouring the technology sector (+19.0pp), largely via US holdings.

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

	Portfolio end October 2019	Portfolio end October 2018	Change (pp)	Index weight	Active weight vs index (pp)	Fund weight/ index weight (x)
Information technology	24.1	19.5	4.6	5.1	19.0	4.7
Industrials	19.0	14.1	4.9	11.1	7.9	1.7
Materials	14.4	17.3	(2.9)	11.3	3.1	1.3
Consumer discretionary	13.3	17.6	(4.3)	4.2	9.1	3.2
Financials	10.5	10.9	(0.4)	33.2	(22.7)	0.3
Energy	7.5	9.9	(2.4)	16.0	(8.5)	0.5
Healthcare	3.0	4.3	(1.3)	1.3	1.7	2.3
Communication services	2.9	3.2	(0.3)	5.5	(2.6)	0.5
Real estate	1.5	1.3	0.2	3.6	(2.1)	0.4
Utilities	0.8	0.7	0.1	4.7	(3.9)	0.2
Consumer staples	0.0	0.0	0.0	3.9	(3.9)	0.0
Cash & cash equivalents	3.3	1.2	2.1	0.0	3.3	N/A
	100.0	**100.0**		**100.0**		

Source: Canadian General Investments, Edison Investment Research. Note: Numbers subject to rounding.

Eckel highlights the new additions to the fund since our last note was published in May 2019.

- **Canadian National Railway (CNR)** provides exposure to US and Canadian economic growth. Its network stretches from the Canadian West to East Coast, through the US Midwest to the Gulf of Mexico. The manager says that CNR is a good, well-run company with an improving, best-in-class operating ratio. Compared with its peer Canadian Pacific (also held in the portfolio), CNR has less exposure to bulk commodities such as coal, grain and potash, with a higher percentage in industrial and intermodal businesses. Eckel comments that the company's investment to upgrade its terminals should result in new business wins.
- **Constellation Software** is a collection of software companies, built via a series of acquisitions. The manager says the company has a steady business with a well-respected management team, high recurring cash flow and robust margins. Since 2013, revenues have compounded at a rate of 20% pa, while earnings over the period have compounded at 25% pa. Constellation is employing merger and acquisition (M&A) staff in the field to replicate operations that were historically undertaken centrally, which the manager believes will lead to increased vigour in the M&A process.
- **MediPharm Labs** – Eckel suggests that MediPharm's business represents the next wave in the cannabis space, as the value-added operations in the chain are the extraction of oils, rather than cannabis production itself. MediPharm is an independent extractor, in a business with high barriers to entry due to regulatory requirements. The company processes cannabis grown by third parties, but also its own product, which generates higher margins.
- **Pluralsight** is a US company providing a programme of online educational training courses for software developers, IT administrators and creative professionals. However, Eckel admits that the firm's sales growth has been a disappointment; he is hopeful that the hiring of a new sales management team will reinvigorate the company's growth profile. Pluralsight is a dominant industry player, whose customers include Amazon, Google and Microsoft.
- **Roper Technologies** is a US diversified industrial company, providing engineered products for global niche markets. It is an active acquirer of businesses, keeping the existing management teams while providing financing and introducing best practices. Roper is a high-growth business, with a robust level of recurring cash flow. The recent CEO transition should be

smooth as the incumbent and their predecessor worked together for 15 years. Eckel believes that this company should sit well in CGI's portfolio for many years.

There has been very little selling activity in the portfolio. Eckel disposed of the residual position in Tahoe Resources rather than tendering the stock in the cash/stock bid from Pan American Silver. The manager has also taken profits in Shopify (still the largest holding), which had appreciated to a greater-than-desired weighting in the portfolio.

Performance: Outperforming over the mid/long term

Exhibit 4: Five-year discrete performance data

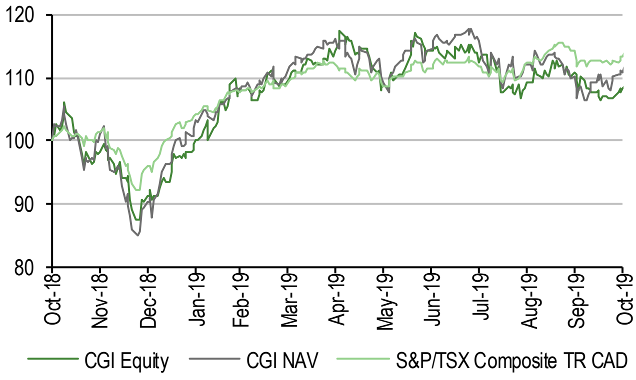
12 months ending	Share price (%)	NAV (%)	S&P/TSX Composite (%)	MSCI Canada (%)	FTSE World (%)
31/10/15	(3.2)	(2.3)	(4.6)	(4.6)	17.2
31/10/16	1.7	7.3	12.7	12.4	5.0
31/10/17	32.2	23.0	11.5	12.1	19.0
31/10/18	2.2	3.1	(3.4)	(3.4)	2.6
31/10/19	8.3	10.7	13.2	12.5	13.2

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

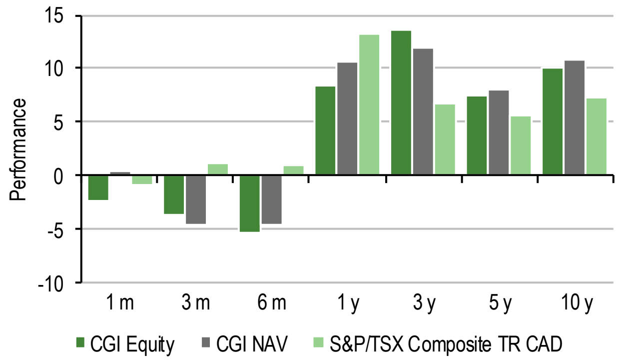
In H119 (ending 30 June), CGI's NAV and share price total returns of +26.5% and +25.4%, respectively, were meaningfully ahead of the benchmark's +16.2% total return. During the period, all 11 sectors of the S&P/TSX Composite Index were in positive territory, but there was a wide divergence of results, with information technology up 43.2%, while communication services only generated a +9.7% total return. There was also a wide range of performances at the stock level. CGI benefited from its sector allocation, including its significant overweighting in technology, along with the large underweight position in financials, a sector that failed to keep pace with the broader market. In terms of the fund's holdings, notable contributors to performance included top 10 positions Shopify (e-commerce) and Air Canada (airline), along with long-term holding Dollarama (retail) and 2019-listed Lightspeed POS (software), while detractors included Canada Goose (apparel), Norbord (building products) and Methanex (chemicals).

Exhibit 5: Investment company performance to 31 October 2019

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.

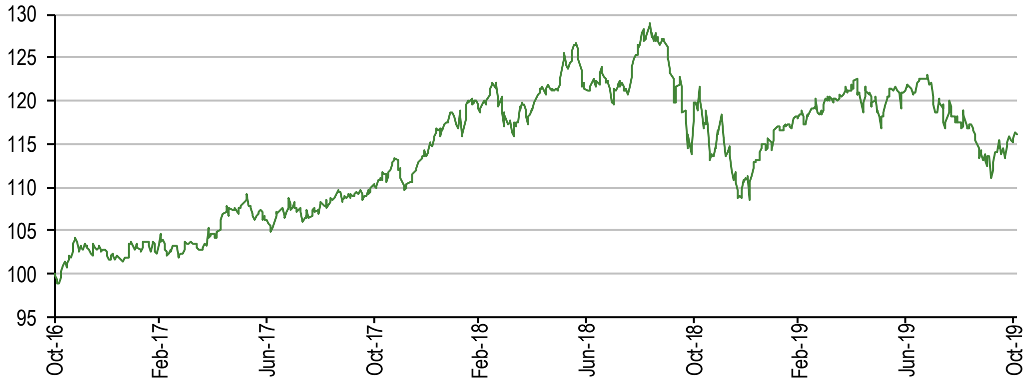
Exhibit 6 shows CGI's relative performance. It has meaningfully outperformed the benchmark in both NAV and share price terms over the last three, five and 10 years. More recent performance has been a little trickier. As shown in Exhibit 7, CGI outpaced the S&P/TSX Composite Index in the early months of 2019 due to positive sector and stock-specific exposure. However, in Q319, there was a sector rotation; Eckel explains that the 'market leaders took a step back and the laggards improved'. Lower interest rates boosted the performance of interest rate sensitive sectors, and CGI has underweight exposures to financials (in particular), real estate and utilities. However, the manager says that this trade has started to reverse, as bond yields are moving up, and CGI's relative performance is improving. The company is also underweight the energy sector, which temporarily rallied following the drone attack on Saudi Arabia's oil facilities. Eckel is confident in the fund's sector positioning and will not change its sector weightings to try to capture short-term moves in the Canadian stock market. Elsewhere in the portfolio, CGI's cannabis stocks have been under pressure. The manager notes that some of this is due to company-specific reasons and some reflects industry-wide concerns. This is a relatively new sector, as cannabis was only approved for recreational use in Canada around a year ago; however, investors – having seen large moves in the listed companies' share prices – are looking for better results and faster progress in their businesses. The manager has taken some profits in Canopy Growth and is evaluating what he will do with CGI's other three holdings in the sector; whatever Eckel decides, any action will be taken after careful deliberation, taking the company's long-term investment horizon into account.

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	(1.4)	(4.8)	(6.2)	(4.3)	20.1	9.9	28.9
NAV relative to S&P/TSX Composite	1.2	(5.7)	(5.6)	(2.3)	15.1	12.2	37.2
Price relative to MSCI Canada	(1.4)	(4.6)	(5.4)	(3.7)	20.2	10.2	32.9
NAV relative to MSCI Canada	1.2	(5.6)	(4.7)	(1.6)	15.2	12.6	41.5
Price relative to FTSE World	(4.2)	(6.3)	(6.6)	(4.3)	5.9	(15.4)	(14.4)
NAV relative to FTSE World	(1.6)	(7.2)	(6.0)	(2.3)	1.5	(13.6)	(8.9)

Source: Refinitiv, Edison Investment Research. Note: Data to end-October 2019. Geometric calculation.

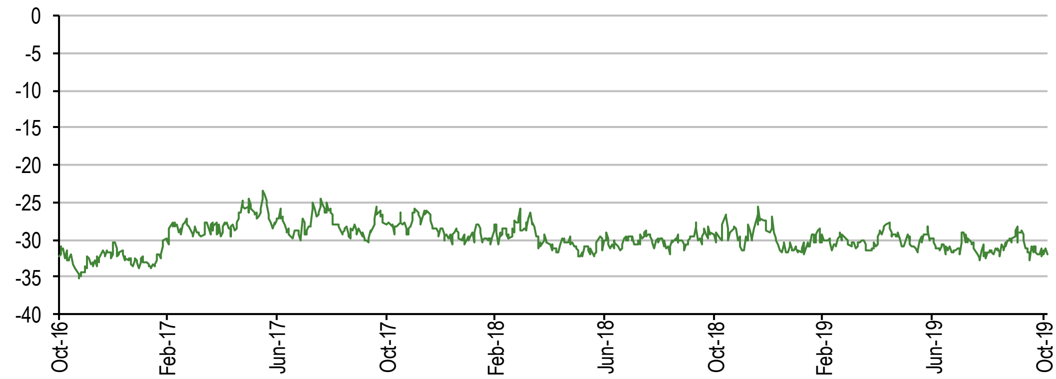
Exhibit 7: NAV total return performance relative to benchmark over three years



Source: Refinitiv, Edison Investment Research

Discount: Trading in a narrow range

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



Source: Refinitiv, Edison Investment Research

Despite its long-term record of outperformance, CGI's shares consistently trade at a wide discount to the fund's NAV. This feature may be due to the 52.5% insider ownership affecting investor perceptions regarding liquidity, although it should be noted that over the last 20 years, there have been brief periods when the company traded at a premium (most recently in 2006).

CGI's shares are currently trading at a 32.4% discount to NAV, which is at the wider end of the 25.7% to 32.8% range of discounts over the last 12 months. It compares with the 30.3%, 29.7%, 28.8% and 27.1% average discounts over the last one, three, five and 10 years, respectively. As noted in the Fund profile section on page 3, 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.

Capital structure and fees

CGI has 20.9m ordinary shares in issue. It has employed a leveraged strategy since its first issue of preference shares in 1998. Until June 2019, the company had C$150m in gearing (C$75m Series 4, 3.75% preference shares, redeemable on or after 15 June 2023, and C$75m bank debt). However, on 5 June 2019, the board announced an amended and restated credit agreement, replacing the C$75m bank debt with a C$100m one-year, non-revolving credit facility. Interest payable on the loan is the greater of the bank's prime rate and the Canadian Deposit Offered Rate (CDOR) plus 1.00% per annum, or bankers' acceptances, which bear interest at the CDOR plus 0.75% per annum. The facility has an evergreen feature, allowing continued use of the loan facility indefinitely beyond the initial one-year term, provided the bank has not given CGI one year's notice of termination.

Eckel explains that the value of CGI's portfolio had grown, and given his comfort with gross gearing around 20%, a larger debt facility was warranted. He believes that leverage, if employed, should be meaningful: 'why bother with 10%', he adds. At end-October 2019, the company's total debt of C$175m equated to gross gearing of 19.5% (16.2% net of cash and equivalents).

MMA is paid an annual management fee of 1.0% of the market value of CGI's investments, net of cash, portfolio accounts receivable and portfolio accounts payable; there is no performance fee. In H119, the annualised management expense ratio (MER) including leverage costs was 2.24% (9bp higher than 2.15% in 2018). Excluding leverage costs makes the MER more comparable with the ongoing charge figure used in the UK. In H119, it was 1.56%, which compares with 1.48% in 2018.

Dividend policy and record

Having been maintained at a total level of 76c per share for six years, based on rising quarterly and reduced special dividends since 2014, FY19's announced total distribution of 80c per share is 5.3% higher year-on-year (four regular dividends of 20c per share and no specials). The board is aiming to increase the company's dividends over time, but will remain prudent in its approach. Based on its current share price, CGI offers a 3.3% dividend yield.

Peer group comparison

There are just two funds in the AIC North America sector with significant Canadian exposure (Exhibit 9), both of which have different investment mandates. CGI has the highest NAV total return over three, five and 10 years, significantly so over three and five years, and is behind its peer over the last 12 months. The company's discount remains consistently wide, which may be due to its high insider ownership. CGI has a higher level of net gearing and a lower dividend yield, which is not unexpected given its focus on total return rather than income.

Exhibit 9: Selected peer group as at 5 November 2019 (C$)*

% unless stated	Market cap (C$m)	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	498.9	10.5	47.7	52.3	177.1	(32.4)	1.6	No	116	3.3
Middlefield Canadian Income	188.0	11.9	18.1	33.1	169.8	(9.4)	1.1	No	106	4.9
Average	**343.4**	**11.2**	**32.9**	**42.7**	**173.4**	**(20.9)**	**1.4**		**111**	**4.1**
Fund rank in sector	**1**	**2**	**1**	**1**	**1**	**2**	**1**		**1**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 4 November 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

There are seven directors on CGI's board, with an average tenure of c 17 years. Three of the members are non-independent: 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 the years they joined the board are Neil Raymond (2002), Richard Whittall (2004), James Billett (2005) and Michelle Lally (2015). The seven directors have backgrounds in investment management, financial consulting and law.

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