EDISON

Canadian General Investments

Successful active management in Canada

Investment companies

Canadian General Investments (CGI) aims to generate an attractive total return from a portfolio of primarily Canadian equities. Manager Greg Eckel describes the fund as a 'one-stop-shop' for investment in Canada. He says that the country is currently out of favour with investors, and equity valuations are reasonable, which may provide an attractive opportunity. While he invests for the long term, Eckel actively manages CGI's portfolio, seeking to buy companies with attractive fundamentals and long-term growth potential, while adding to or trimming existing positions to maximise returns. This strategy has proved effective, with CGI outperforming its S&P/TSX Composite index benchmark over one, three, five and 10 years. It also offers an attractive dividend yield of 3.5%.

12 months ending	Share price (%)	NAV (%)	S&P/TSX Composite (%)	MSCI Canada (%)	FTSE World (%)
30/09/14	24.4	23.8	20.4	21.4	21.8
30/09/15	(4.7)	(6.8)	(8.4)	(8.0)	13.0
30/09/16	5.3	10.9	14.2	13.1	10.3
30/09/17	24.3	17.5	9.2	10.2	13.4
30/09/18	21.1	23.8	5.9	6.1	14.7

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

Investment strategy: Seeking long-term winners

Eckel's unconstrained investment approach is illustrated by large divergences in sector exposure compared with the benchmark, such as overweight positions in technology and consumer discretionary stocks, and a meaningful underweight in financial companies. He seeks firms with robust fundamentals and strong management teams. While the majority of the portfolio is invested in Canadian equities, up to 25% may be in US companies to take advantage of investment opportunities unavailable in Canada.

Market outlook: Pullback may provide opportunity

The Canadian stock market has not been immune to macro uncertainties, which include trade tensions due to President Trump's 'America First' strategy. A pullback in equities has resulted in more attractive Canadian company valuations. In terms of the forward P/E multiple, in aggregate, Canadian shares are trading at a 16.2% discount to their five-year average, and at a much wider discount compared with US equities than the average over this period. For investors with a longer-term view, near-term weakness in Canadian equities may provide an opportunity.

Valuation: Discount in a narrow band

Since early 2017, CGI's discount to NAV has been in a narrow band; its current level of 29.2% compares with the average discounts over the last one, three, five and 10 years of 29.4%, 28.9%, 28.8% and 26.4% respectively. The fact that the discount is persistently wide, despite the company's positive long-term performance track record, may be because of the high level of insider ownership, or due to its relatively high level of gearing. To enable CGI to maintain its favourable tax status, the board is unable to repurchase shares to help manage the discount.

30 October 2018

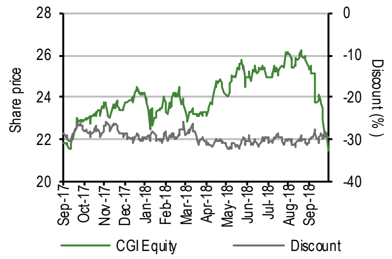
Price	**C$21.51**
Market cap	**C$449m**
AUM	**C$784m**

NAV*	C$30.40
Discount to NAV	29.2%
Yield	3.5%

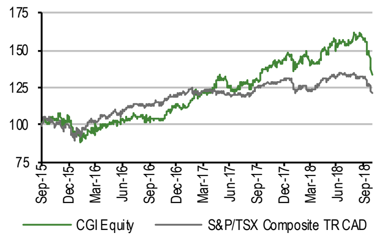
*Including income. As at 29 October 2018.

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

Share price/discount performance



Three-year performance vs index



52-week high/low	C$26.24	C$21.51
NAV** high/low	C$37.54	C$30.40

**Including income.

Gearing

Gross*	16.4%
Net*	16.0%

*As at 30 September 2018.

Analysts

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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

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.

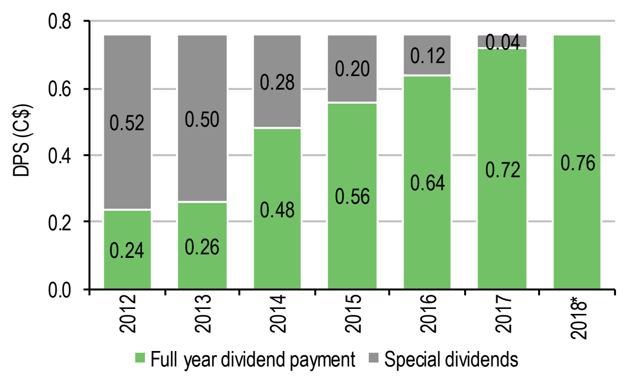
Recent developments

- 17 October 2018: Announcement of quarterly dividends – C$0.19 per common share and C$0.23438 per Series 4 preference share.
- 31 August 2018: Interim report for six months ending 30 June 2018. NAV total return of +9.0% versus +1.9% for the S&P/TSX Composite Index. Share price total return +6.8%.
- 19 July 2018: Announcement of quarterly dividends – C$0.19 per common share and C$0.23438 per Series 4 preference share.

Forthcoming		Capital structure		Fund details	
AGM	April 2019	Ongoing charges	1.52% (see MER below)	Group	Morgan Meighen & Associates
Final results	March 2019	Net gearing	16.0%	CEO	Jonathan A Morgan
Year end	31 December	Annual mgmt fee	1.0% (see page 7)	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 7)	Website	www.mmainvestments.com

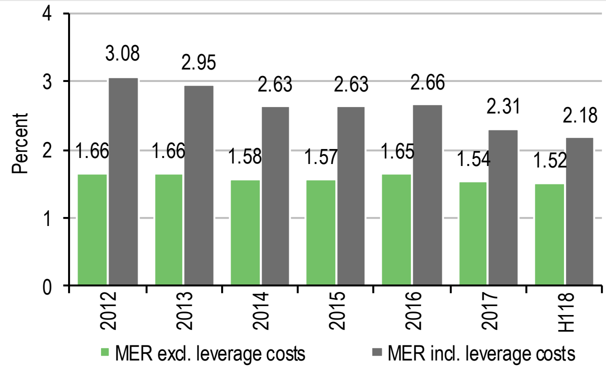
Dividend policy and history (financial years)

CGI revised its dividend policy in 2014, intending to pay steady to rising quarterly dividends with less emphasis on the special final dividend. Note: *For 2018, four announced dividends of C$0.19 (three already paid).

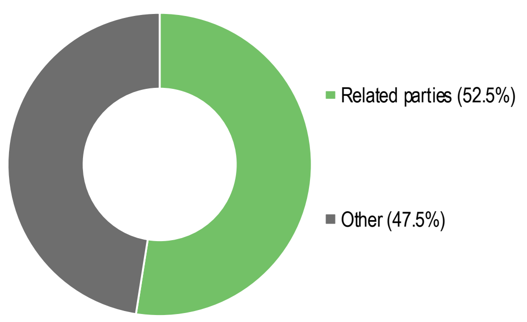


Management expense ratio (MER)

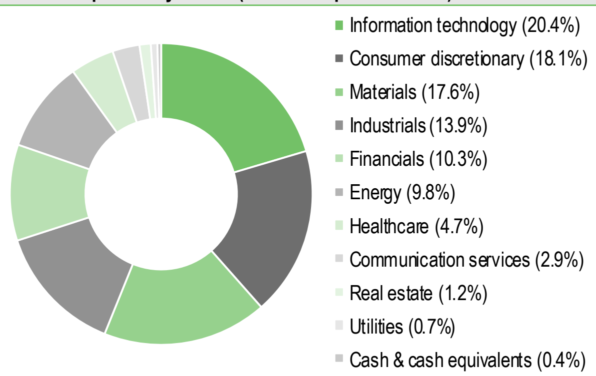
CGI pays a monthly management fee at 1.0% per year of gross assets. Leverage costs include preference share dividends, interest and financing charges.



Shareholder base (as at 30 September 2018)



Portfolio exposure by sector (as at 30 September 2018)



Top 10 holdings (as at 30 September 2018)

			Portfolio weight %	
Company	**Country**	**Sector**	**30 September 2018**	**30 September 2017***
NVIDIA Corporation	US	Semiconductors	5.3	4.3
Amazon.com	US	Online retail	4.9	N/A
Shopify	Canada	Internet services	4.3	3.4
Canada Goose	Canada	Apparel	3.7	N/A
Air Canada	Canada	Airlines	3.5	3.8
Canadian Pacific Railway	Canada	Railroads	3.4	3.1
Canopy Growth Corporation	Canada	Speciality pharma	3.4	N/A
Mastercard	US	Financial transaction processing	3.3	N/A
Bank of Montreal	Canada	Banks	3.2	3.3
Dollarama	Canada	Multiline retail	3.2	5.7
Top 10			**38.2**	**36.6**

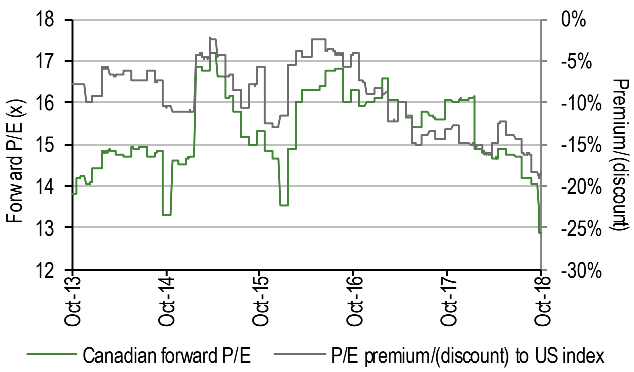
Source: Canadian General Investments, Edison Investment Research, Bloomberg, Morningstar. Note: *N/A where not in end-September 2017 top 10.

Market outlook: Relatively attractive equity valuations

Canadian equities, along with those of global companies, are currently experiencing higher levels of volatility compared to the very benign levels in 2017. Exhibit 2 (LHS) shows the average valuation of Canadian equities over the last five years. The current forward P/E multiple of 12.9x is 16.2% lower than the five-year average. In relative terms, the Canadian market is 18.3% cheaper than the US; this is much wider than the 9.5% average discount over the last five years, which may provide an opportunity for investors seeking differentiated North American equity exposure.

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 29 October 2018)

	No of cos	Weight (%)	Ytd 18 total return (%)	2017 total return (%)	2018e P/E (x)
Financials	27	34.2	(6.0)	13.3	11.0
Energy	48	18.7	(11.5)	(7.0)	16.5
Industrials	28	10.6	2.4	19.7	18.3
Materials	53	10.3	(16.3)	7.5	18.5
Comm'n services	7	5.6	(5.1)	14.8	15.4
Cons. discretionary	17	4.4	(12.1)	22.8	12.6
Utilities	16	4.0	(9.5)	10.8	19.5
Information tech.	11	3.9	9.6	16.8	22.8
Consumer staples	10	3.6	(6.6)	7.8	15.8
Real estate	22	3.2	4.6	11.2	N/A
Healthcare	8	1.6	(2.5)	34.2	22.4
Index	**247**	**100.0**	**(7.0)**	**9.1**	**14.3**

Source: Thomson Datastream, Bloomberg, Edison Investment Research

Exhibit 2 (RHS) shows the breakdown of the bellwether S&P/TSX Composite index. While investors may associate the Canadian stock market with financial and resource stocks, the financial, energy and materials sectors in aggregate only make up around 50% of companies in the index. This suggests that there may be a wider selection of available investment opportunities in Canada than generally understood. A key feature of the Canadian stock market during 2018 has been the wide disparity of returns in individual sectors, which means that investors could be rewarded by focusing on a fund with a long-term record of successful stock selection.

Fund profile: Diverse exposure to Canadian equities

CGI was launched in January 1930. It is the second-oldest North American closed-end fund and is quoted on the Toronto Stock Exchange (since 1962) and the London Stock Exchange (since 1995). Since 1956, CGI has been managed by Morgan Meighen & Associates (MMA), a Canadian investment firm, which has c C$1.8bn assets under management. The fund's lead manager is Greg Eckel (since 2009); he invests for the medium to long term, aiming to outperform the benchmark S&P/TSX Composite index by investing in a diverse portfolio of primarily Canadian, along with selected US equities.

The company is designated as an investment corporation under the Income Tax Act (Canada). This eliminates a layer of taxation, as capital gains are only taxed at the shareholder level, and enables CGI's capital gains to be paid as dividends to shareholders. However, in order to maintain this favourable tax status, the company is unable to repurchase its shares to help manage the share price discount to net asset value. No more than 25% of the company's gross revenue may be from interest income, and at least 85% of its gross revenue must be from Canadian sources. More than 50% of CGI's shares are held by related parties which, along with its high level of structural gearing, may contribute to its wide discount to NAV. The company has C$150m debt: C$75m Series 4, 3.75% preference shares and C$75m bank debt; at end-September 2018, net gearing was 16.0%. CGI has followed a leveraged strategy since its first issue of preference shares in 1998.

Data from MMA highlight CGI's very long-term record of outperformance. Over the last 25 years to end-December 2017, its average annual share price total return of 10.6% is 1.6pp ahead of the benchmark. Its outperformance over 50 years is even larger, at 2.1pp pa (11.4% versus 9.3%).

The fund manager: D Greg Eckel

The manager's view: Importance of individual stock selection

Eckel notes that so far in 2018, the Canadian stock market – along with the majority of those in other regions – has lagged the performance of US shares, which have been supported by a robust domestic economy and tax cuts. He says that economic conditions in Canada are steady, with GDP growth of around 2%, and the recent breakthrough in trade negotiations with the US is positive, although this event has not been reflected by an upward move in the Canadian stock market. The manager believes that domestic economic growth should feed into corporate earnings, providing support for Canadian equity prices. He is hopeful that Q318 earnings reports will be robust; consensus expectations are for a double-digit, year-on-year increase, although Eckel says that forward guidance will be an important barometer for investor sentiment.

So far this year, CGI has benefited from overweight exposures in sectors that have outperformed, such as technology, industrials and healthcare. However, the manager notes that in aggregate, Canadian stock price performance at the individual company level has been 'spotty'. He says that 2018 has seen a wide range of equity returns within sectors, highlighting the importance of bottom-up stock selection. Eckel describes the current investment environment as 'difficult', and comments that Canadian share price weakness so far in October has dragged the index into negative territory for the year to date.

Energy makes up around 20% of the benchmark, but is lagging the index so far in 2018, despite a big upward move in the oil price. Eckel says that Canadian crude prices (measured by the benchmark Western Canadian Select) are trading at a record discount to US crude prices (West Texas Intermediate), which is partly due to a lack of available transport infrastructure. He says that Canadian integrated energy company, Cenovus Energy, has recently struck a deal with a railroad to transport 200k barrels of oil a day, but this comes at a price and will squeeze margins. Eckel also notes that the timeline for a Federal government pipeline project has been pushed back due to political and environmental issues, which has also tempered investor enthusiasm for the energy sector. The manager recently attended an oil and gas conference, where he saw companies demonstrating robust fundamentals, such as volume growth and strong cash flows. However, he notes that two large Canadian pipeline companies, Enbridge and TransCanada Pipeline, are experiencing a lack of investment opportunities, despite having plenty of available capital.

Asset allocation

Investment process: Investing for the longer term

Eckel aims to provide better-than-average total returns to investors via prudent stock selection and timely recognition of capital gains and losses, as well as generating an attractive level of income. He primarily invests on a bottom-up basis, while also taking the macro environment into account. The majority of the portfolio is invested in Canadian equities, while up to 25% may be invested in US companies to capitalise on businesses unavailable in Canada, such as the top 10 positions in semiconductor company NVIDIA, online retailer Amazon.com and payment processor Mastercard. The manager has a long-term investment approach, and many of CGI's positions have multi-year holding periods, although they are continually assessed to ensure their exposures remain appropriate. He seeks companies with strong fundamentals and long-term growth potential, which are trading on reasonable valuations. There is a focus on the quality of a company's management, and Eckel has a history of following good management teams when they transition to other companies, often as a result of mergers or acquisitions.

In early 2016, CGI's portfolio was restructured, with changes including a higher weighting in commodities. The restructuring benefits are shown by the fund's increased outperformance versus the benchmark (Exhibit 6). The majority of the portfolio is made up of mid- and large-cap stocks (holdings have a median market cap of c C$8bn), and less than 5% of the portfolio has a market cap below C$1bn. Some of CGI's positions offer higher dividend yields, such as Bank of Montreal and Royal Bank of Canada, which support the fund's own dividend payments.

Current portfolio positioning

At end-September 2018, CGI's top 10 positions made up 38.2% of the portfolio, which was a higher concentration compared with 36.6% a year earlier; six positions were common to both periods. The fund had 76.6% of its portfolio (-6.9pp year-on-year) in Canadian equities, 23.0% (+6.9pp) in US equities, and 0.4% (flat versus a year earlier) in cash and equivalents. Compared with the benchmark, CGI's structure is broadly similar to when we last published a report on the company in April 2018; exposure to each individual sector is capped at 35%. Portfolio turnover has been trending lower; it was just 1.9% in H118, which compares with 10.4% in 2017 (towards the low end of the 9-25% annual historical range) and a five-year average of 17.0%.

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

	Portfolio end September 2018	Portfolio end September 2017	Change (pp)	Index weight	Active weight vs index (pp)	Fund weight/ index weight (x)
Information technology	20.4	15.0	5.4	4.1	16.3	5.0
Consumer discretionary	18.1	15.8	2.3	4.4	13.7	4.1
Materials	17.6	20.5	(2.9)	10.1	7.5	1.7
Industrials	13.9	13.1	0.8	10.6	3.3	1.3
Financials	10.3	13.4	(3.1)	34.3	(24.0)	0.3
Energy	9.8	14.8	(5.0)	19.1	(9.3)	0.5
Healthcare	4.7	0.0	4.7	2.0	2.7	2.4
Communication services	2.9	3.3	(0.4)	5.3	(2.4)	0.6
Real estate	1.2	1.1	0.1	3.1	(1.9)	0.4
Utilities	0.7	0.9	(0.2)	3.7	(3.0)	0.2
Consumer staples	0.0	1.7	(1.7)	3.4	(3.4)	0.0
Cash & cash equivalents	0.4	0.4	0.0	0.0	0.4	N/A
	100.0	**100.0**		**100.0**		

Source: Canadian General Investments, Edison Investment Research

Canada has been in the news recently as only the second country in the world to legalise the recreational use of cannabis. CGI holds positions in two companies in the sector, Aphria and Canopy Growth. Eckel says that legislative changes are occurring faster than generally anticipated, not just in Canada, but also in the UK for medicinal use. The sector's growth potential has not gone unnoticed, with US consumer goods company Constellation Brands recently increasing its stake in Canopy Growth from c 10% to c 40%, leading to a more than 20% upward move in the cannabis producer's share price. There have also been indications that a US tobacco company is considering making an investment in Aphria. While these two stocks still have upside potential, Eckel acknowledges that they are also riskier than the majority of names in CGI's portfolio, and therefore warrant a modest weighting to mitigate risk (currently c 5%).

CGI participated in the initial public offering of IPL Plastics in June 2018. Eckel says that the company has good fundamentals and is well run by a solid management team. The firm is broadening its reach in the North American packaging market, and its speciality products generate higher margins than more commodity-like offerings. Another new holding in the portfolio is payments processor Square, which is benefiting from growth in mobile billing, as this is easier and more efficient than legacy processes. The company is increasing the size of its product offering, such as advancing credit, which allows merchants to expand their businesses. Eckel believes that

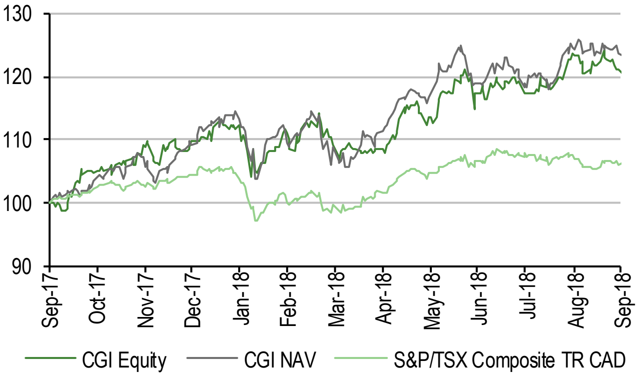
Square has good growth potential, both in North America and overseas markets, referring to CGI's position as 'a good one to be in for the long term'.

Performance: Building on long-term record

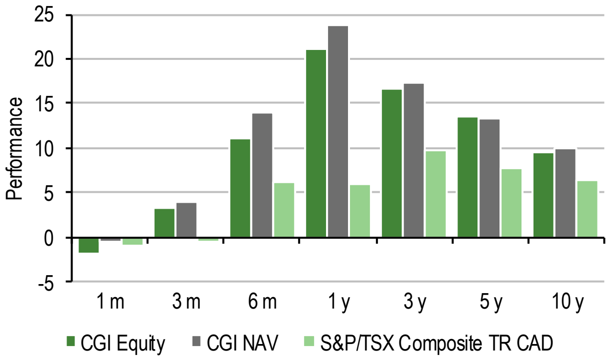
In H118 (to 30 June), CGI's NAV and share price total returns of +9.0% and +6.8% respectively were meaningfully ahead of the benchmark's +1.9% total return. This was a result of both positive asset allocation and good stock selection. In terms of sectors, the company had an overweight exposure in four out of the six industry groups that generated positive returns over the period (technology, industrials, consumer discretionary and materials), while being underweight in the four worst-performing sectors (utilities, telecoms, consumer staples and financials). At a stock level, positive contributors included apparel manufacturer Canada Goose (+94.7%), e-commerce company Shopify (+50.8%) and cannabis producer Canopy Growth (+29.2%).

Exhibit 4: Investment company performance in Canadian dollars to 30 September 2018

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



Price, NAV and benchmark total return performance (%)



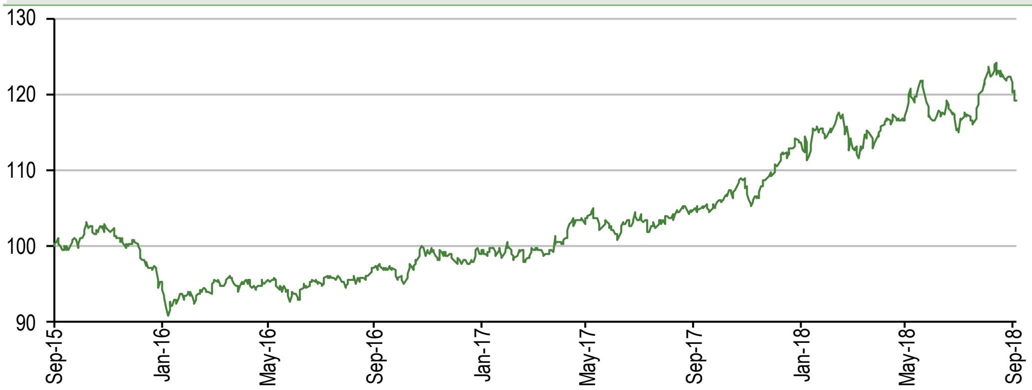
Source: Thomson Datastream, Edison Investment Research. Note: Three-, five- and 10-year performance figures annualised.

Exhibit 5: 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	(0.9)	3.9	4.6	14.4	20.0	28.9	33.6
NAV relative to S&P/TSX Composite	0.3	4.6	7.3	16.9	22.1	27.8	39.9
Price relative to MSCI Canada	(0.9)	4.2	4.6	14.1	19.8	27.2	36.8
NAV relative to MSCI Canada	0.3	4.8	7.3	16.7	22.0	26.1	43.3
Price relative to FTSE World	(1.6)	0.3	4.7	5.6	10.4	(5.0)	(14.0)
NAV relative to FTSE World	(0.4)	0.9	7.4	8.0	12.4	(5.8)	(10.0)

Source: Thomson Datastream, Edison Investment Research. Note: Data to end-September 2018 in C$ terms. Geometric calculation.

Exhibit 6: NAV total return performance relative to benchmark over three years



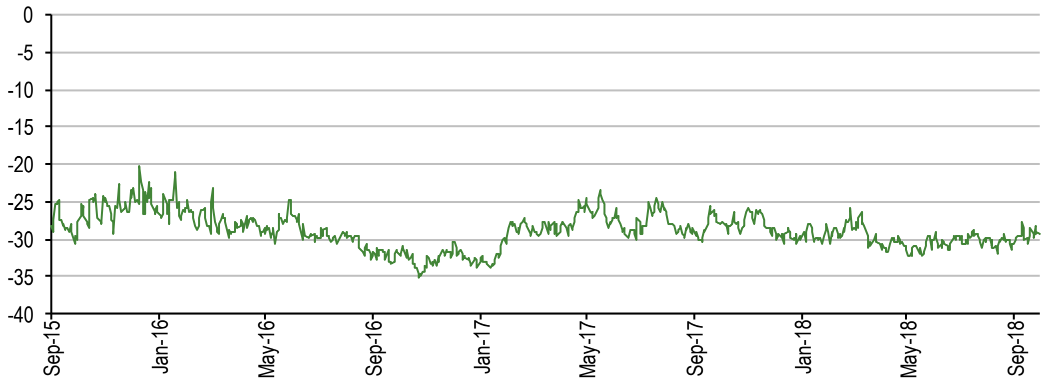
Source: Thomson Datastream, Edison Investment Research

CGI's relative performance is highlighted in Exhibits 5 and 6. The company has outperformed the benchmark over almost all periods shown in both NAV and share price terms, with the one-year excess returns being particularly notable. CGI's portfolio was successfully repositioned in early 2016, with changes including a higher weighting in the materials sector; since then the fund has outperformed the index by around 30pp.

Discount: Similar to historical averages

CGI's shares are currently trading at a 29.2% discount to NAV, which is broadly similar to the average discounts of the last one, three, five and 10 years (range of 26.4% to 29.4%). The discount remains persistently wide despite the company's very long-term positive relative performance record. This may be due to the high level of insider ownership, the relatively high level of structural gearing, or a lack of investor appetite for Canadian equities. To preserve CGI's favourable tax status, it is unable to repurchase its shares to help manage the discount.

Exhibit 7: Share price discount to NAV (including income) over three years (%)



Source: Thomson Datastream, Edison Investment Research

Capital structure and fees

CGI has 20.9m ordinary shares in issue and gearing of C$150m, made up of C$75m in Series 4, 3.75% preference shares and C$75m in bank debt, taken on in June 2016 before the redemption of C$75m Series 3, 3.90% preference shares. The bank debt has an interest rate of 2.28%, lowering CGI's average cost of debt from 3.825% to 3.015%, and saving C$1.215m in annual interest costs. At end-September gross gearing was 16.4% (16.0% net of cash).

MMA is paid an annual management fee of 1.0% pa of the market value of CGI's investments, net of cash, portfolio accounts receivable and portfolio accounts payable; no performance fee is payable. In H118, the annualised management expense ratio (including leverage costs) was 2.18% (13bp lower than in FY17), while excluding leverage costs the ratio was 1.52% (2bp lower than in FY17). The fee, excluding leverage costs, is more comparable with the ongoing charges ratio that is used in the UK.

Dividend policy and record

Starting in 2014, there has been a greater emphasis on regular quarterly dividends rather than a special year-end dividend (see Exhibit 1). Given the four C$0.19 interim dividends announced for FY18 (total distribution of C$0.76, which is in line with each of the last six years), it is likely that 2018 could be the first year when no special dividend is paid. Eckel is hopeful that over time, the regular quarterly dividends will increase. Based on its current share price, CGI offers a dividend yield of 3.5%.

Peer group comparison

There are two funds in the AIC North America sector with significant Canadian exposure. While they have different investment mandates, a comparison has some relevance. CGI's NAV total returns rank first over three, five and 10 years, and second over one year. CGI trades at a much wider discount, which may be due to reasons suggested in the Discount section of this report; it also charges higher fees. Both funds have a similar level of gearing, while CGI has a lower dividend yield, befitting its focus on total return rather than income.

Exhibit 8: Selected peer group as at 29 October 2018 (C$)*

% unless stated	Market cap	NAV TR 1 year	NAV TR 3 year	NAV TR 5 year	NAV TR 10 year	Discount (ex-par)	Ongoing charge	Perf. fee	Net gearing	Dividend yield (%)
Canadian General Investments	448.7	2.5	30.5	49.3	206.9	(30.0)	1.5	No	116	3.5
Middlefield Canadian Income	167.6	3.4	17.6	30.9	192.0	(14.4)	1.0	No	119	5.4
Average	**308.2**	**2.9**	**24.0**	**40.1**	**199.4**	**(22.2)**	**1.3**		**117**	**4.5**
Fund rank in sector	**1**	**2**	**1**	**1**	**1**	**2**	**1**		**2**	**2**

Source: Morningstar, Edison Investment Research. Note: *Performance data to 26 October 2018. 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, four of whom are independent of MMA. Chairman Vanessa Morgan (president and CEO of MMA) was appointed in 1997. Jonathan Morgan (president and CEO of CGI, and executive vice president of MMA) was appointed in 2001. Michael Smedley (executive vice president and CIO of MMA) was appointed 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 16 years.

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