24 November 2017

Canadian General Investments*

Buy: Strong performance, attractive dividend

Fund in the spotlight: CGI LN

Discount: 28.2% as at 21 Nov 2017

Source: Morningstar

Mkt Cap: £285.7m
Gross Assets: £493.2m
Net Assets: £404.5m
Gearing: 22%
Dividend yield: 3.3%

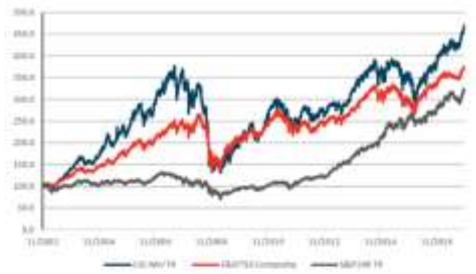
The Canadian economy expanded at a blistering pace (c.4%) in the first half of 2017. Having raised rates twice to 1%, the Bank of Canada (BoC) has paused to let the markets and the economy absorb these rises. In 2017, the equity market performance has been relatively muted following a strong 2016, partially because of uncertainty about NAFTA. However, from a bottom-up perspective, the portfolio manager of Canadian General Investments (CGI), Greg Eckel, continues to find attractive opportunities and CGI has outperformed the benchmark S&P/TSX Composite over one, three and five years. We believe the dividend yield is another key reason to buy CGI for a combination of income and strong long-term returns.

A strong economy waiting for inflation

Following strong growth in the Canadian economy in the first half of the year the BoC expects a slightly slower pace of growth for the rest of the year although it still predicts 3.1% growth for 2017. For 2018, it forecasts the Canadian economy to grow by 2.1%. The Canadian equity market has underperformed most developed equity markets in 2017, so far, following a strong performance in 2016. Following the recent rally, oil prices are now at a level where they are no longer a headwind for the Canadian economy. Inflation still seems to be subdued although the governor of the BoC believes that inflation should rise from current levels.

Figure 1: Canadian GDP growth (%)

Figure 2: CGI NAV performance



Source: Bloomberg, Morningstar

CGI: Continued outperformance

Canadian General Investments has outperformed the TSX Index during 2017, rising 16% as at 31 October 2017, well ahead of the S&P/TSX Index benchmark's total return of 7.3%, driven by stock selection. Over the long term the fund has outperformed the TSX Index as well. The fund's 12-month trailing dividend yield, which stands at c.3.3%, is another key attraction. CGI is dual listed (in Toronto and London) and is trading at the wider end of its discount range. Given the ownership structure of the fund, it cannot buy back shares without losing its preferential tax structure. We note that the discount has narrowed by 4% over the last 12 months [but still stands at c.28%] and see scope for further discount contraction in the medium to long-term. We believe that given the consistently strong relative performance of CGI over the medium to long-term, the dividend yield and the discount it is an ideal vehicle for investors looking to increase their exposure to North American equities.

Priced at close
23 November 2017

Analyst
Saumya Banerjee
020 7601 6629
saumya.banerjee@stockdalesecurities.com

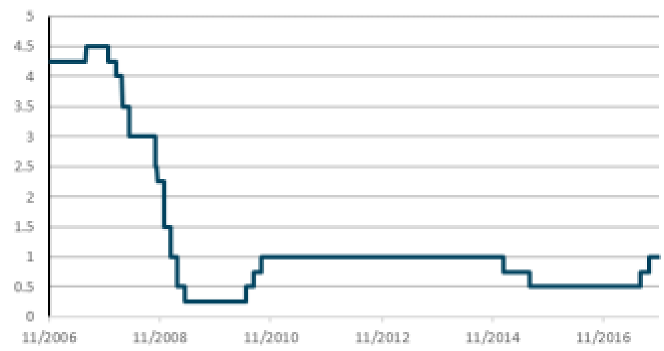
*Stockdale acts as broker and/or advisor to this company

Canada: A strengthening economy, waiting for inflation

Strong growth in H1 has allowed the central bank to raise rates

The Canadian economy grew rapidly in the first half of 2017. This allowed the Bank of Canada (BoC) to raise rates back to 1%. The BoC has stated that it is likely to pause and assess the impact the current set of rate hikes has had on the consumer. As we can see from Figure 3 below, interest rates in Canada have not exceeded the current level since 2008. Thus, until the uncertainty surrounding NAFTA is resolved and inflation increases, we are unlikely to see a substantial rise in rates.

Figure 3: Canadian short term interest rates



Source: Bloomberg

Figure 4: Canada CPI Ex Food & Energy (%, YoY, NSA)

Source: STCA-Statistics Canada

Housing market in larger metropolitan cities seems to be overextended

House prices remain elevated in Canada, despite the introduction of macro-prudential measures in various cities, including surcharges that has been imposed on foreign buyers in Vancouver and Toronto. While there were heightened concerns about the solvency of Home Capital Group (HCG CN) and the broader implications for the Canadian housing market towards the middle of the year we note that the panic has somewhat abated. Interestingly, CGI exited their position in HCG before the concerns arose, but held on to their position in a company viewed similarly by the market, Genworth MI Canada (MIC CN).

Figure 5: Canadian new housing price index (% YoY)

Source: STCA-Statistics Canada

Figure 6: HCG & MIC share prices (CAD)

Source: Bloomberg

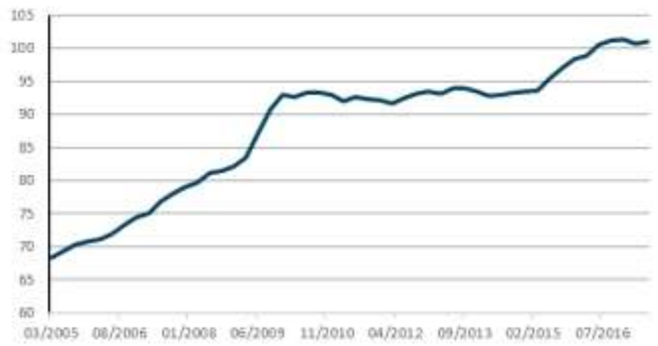
The regulatory authorities continue to tighten the rules for borrowers in the non-prime segment making it even more difficult for those with less than a 20% down payment to secure a home loan. Lenders need to test the ability of borrowers to pay the greater of the BoC's five-year benchmark rate or two percentage points higher than the offered mortgage rate starting in January.

We believe that the risk to the Canadian financial system is overstated by the household debt data (see Figure 7). Unlike the US where the bank extending a loan on a house may not in general have recourse to the other assets of the individual, in Canada it is very difficult to 'walk away from a mortgage'. This has historically led to low levels of mortgage arrears.

BoC expects inflation to rise from current levels given the unemployment rate

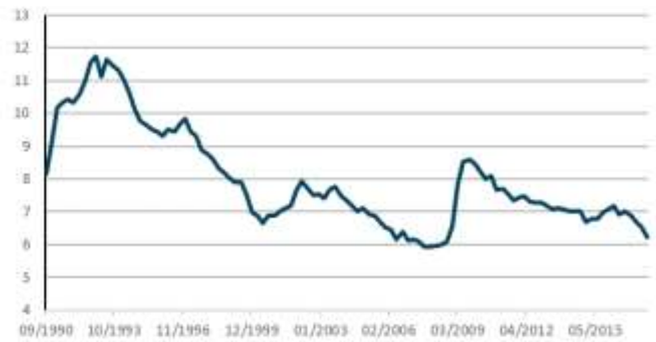
Nevertheless, the Canadian consumer remains highly indebted and thus we are only likely to see modest rate rises in Canada, going forward. Unemployment has now fallen below the 6.6% to 7.3% range where it had hovered between 2013 and 2016, which has lead the BoC to anticipate that inflation should begin to rise from current levels. The BoC expects growth to decline from the lofty levels of 2017 but still anticipates growth above 2% in 2018. It estimates growth will decline to 1.7% in 2019.

Figure 7: Household debt as % of GDP



Source: IMF

Figure 8: Unemployment rate (%)



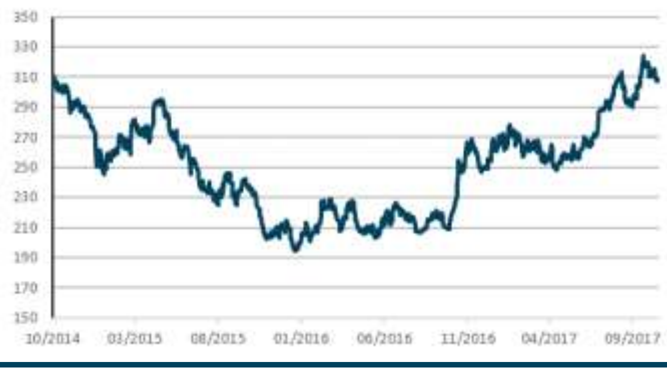
Source: Bloomberg Intelligence

With the recent rise in commodity prices one of the major headwinds that was facing a section of the Canadian economy has abated. Eckel believes that oil prices around current levels will allow current production levels to be maintained and support a measure of output growth in Canada, predominantly in the shale oil and oil sands space.

Figure 9: Brent crude prices (USD)

Source: Bloomberg

Figure 10: Copper prices (USD)



Source: Bloomberg

The BoC seems to be happy with the Canadian dollar trading in a range vis-à-vis the US dollar. It has used verbal intervention to ensure that the Canadian dollar does not strengthen past 1.25 or weaken beyond 1.45 vs the US dollar. This range has been identified by Eckel as one which provides a modest tailwind for the Canadian economy.

Fund structure, management style, performance and outlook

Canadian General Investments (CGI) is a closed-end equity fund focused on medium- to long-term investments in Canadian corporations. It strives, through prudent security selection, timely recognition of capital gains/losses and appropriate income-generating instruments, to provide better than average returns to investors. CGI was established in 1930 and has been managed since 1956 by Morgan Meighen & Associates Limited (www.mmainvestments.com). It is dual-listed on the Toronto Stock Exchange and the London Stock Exchange.

Morgan Meighen and Associates has been managing the fund since 1956

Morgan Meighen and Associates has more than C$1.8bn assets under management. Greg Eckel is CGI's portfolio manager and he works closely with Jonathan Morgan, President and CEO of CGI. The fund is managed through bottom-up stock selection tools although attention is paid to the macroeconomic environment as well. Focus is placed on companies with strong managements that have a unique offering, market leading positions, or are in transition.

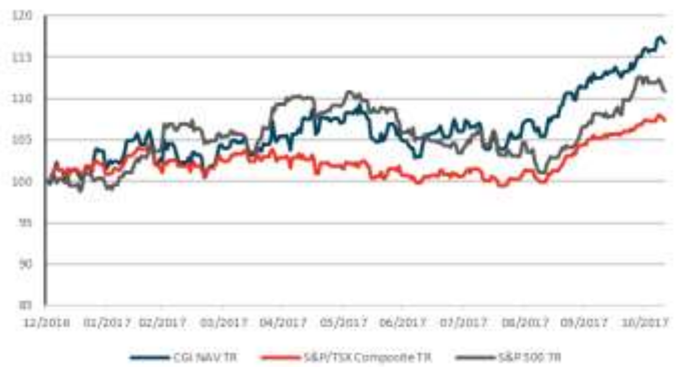
Diversified portfolio

As at the end of October 2017 the fund had 54 holdings with more than 97% of the portfolio having a market cap of more than C$1bn. The fund can invest up to 25% of its assets in the US. Given the interlinkages between the Canadian and US economies there are often interesting plays in the US and Canadian equity markets that have a significant presence in each other's economy.

Figure 11: Canadian dollar range (vs USD)

Source: Bloomberg

Figure 12: YTD performance vs S&P TSX and S&P 500 (CAD)



Source: Morningstar

As we can see in Figure 12, YTD the TSX Composite Index has underperformed the S&P 500 substantially. There are various factors that may have contributed to this underperformance. These include expectations of corporate tax reform in the US, the increase in the value of the CAD as well as concerns about the future of NAFTA and its implications for various industries in Canada. Eckel believes that with Canada and the US being each other's largest export markets with long-standing processes and integration, there is a good possibility that there should be a resolution of trade issues that do not disrupt most of the existing relationships.

Dollarama (DOL CN) remains the fund's largest holding and its stock price continues to deliver strong returns, reflective of the company's consistently impressive quarterly results. DOL provides general merchandise through discount retail stores with items priced at C$4 or less. The company has delivered strong earnings growth since it IPO is 2009 and has been using its excess earnings to grow dividends and buy back shares. CGI has had a position in DOL since its IPO.

Figure 13: DOL share price performance (CAD)

Source: Bloomberg

Figure 14: AMZN share price performance (CAD)

Source: Bloomberg

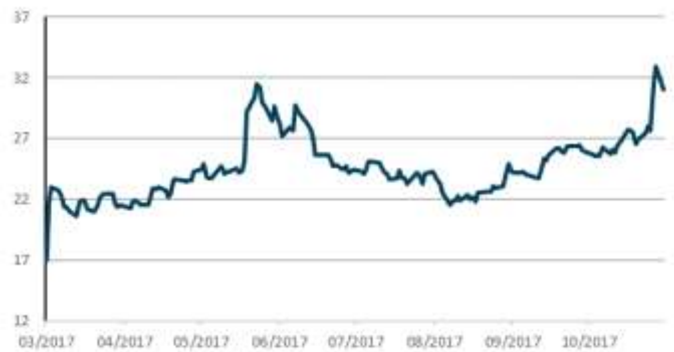
As at the end of October 2017, 17.5% of the fund's assets were invested in US equities. These included stocks such as Amazon (AMZN US), which Eckel sees as having a significant presence in both online retail and cloud services. Other US listed stocks in the portfolio include companies like NVIDIA Corp (NVDA US), which has established itself as one of the key players in areas like autonomous cars, artificial intelligence and graphics for gaming.

Both the long-term nature of the portfolio and diverse nature of returns is evident from Brookfield Canada Office Properties (BOX-U CN) which was taken over in 2017. Originally bought in 2001, the investment in BOX-U was predicated on its ownership of many premium office properties in Canada and provided CGI with both income and growth through the years. BOX-U had many of the attributes that the portfolio manager seeks – long-term potential, quality metrics, growth, income, uniqueness, management skill and competitive barriers.

Figure 15: BOX-U price performance (CAD)

Source: Bloomberg

Figure 16: GOOS price performance since IPO (CAD)



Source: Bloomberg

Canada Goose Holdings (GOOS CN) is a recent addition to the portfolio which may display several of these characteristics. Eckel believes that we should see strong near and medium-term growth from this well-established brand as it relies increasingly on its own stores and e-commerce.

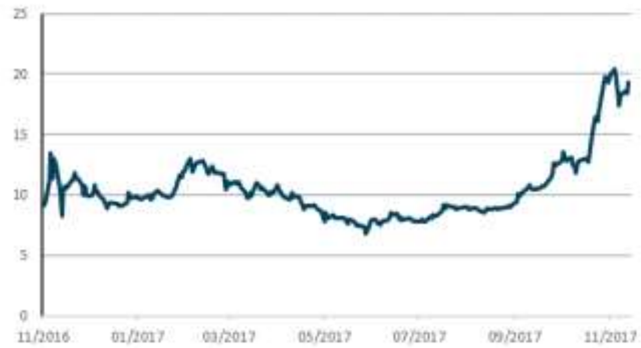
The fund has an official limit of 10% in any individual holdings. However, in general, the manager is looking for opportunities to take profits if a position is above 5%, as has been the case with stocks like Dollarama.

Mid and large cap bias. Modest turnover

The fund has a mid and large cap bias, with 97% of the fund being invested in companies with a market cap over C$1bn, as at the end of October 2017. The median market cap of the fund, which had 54 holdings, was C$9.3bn as at the end of October. The annual portfolio turnover tends to around 13-20%. For the five years ending December 2016, the average turnover was 17.6%.

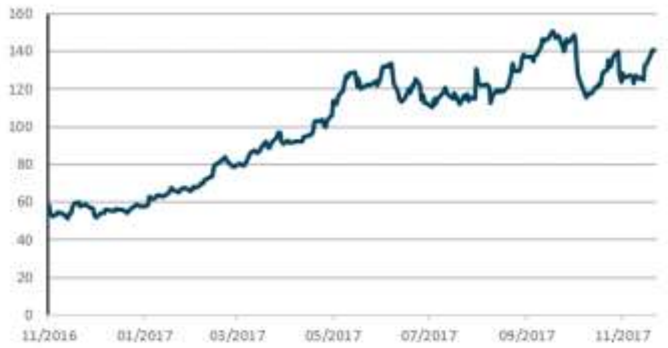
Despite the turnover being modest, Eckel is regularly looking for new investment ideas. Two relatively new entrants to the portfolio are Canopy Growth Corp (WEED CN) and Shopify Inc (SHOP CN). WEED is the largest company by market cap in the emerging cannabis industry in Canada. Legalisation of recreational marijuana is underway and is expected to be finalised in July 2018. Although there remains a fair degree of uncertainty, prospects for companies that succeed in the new multi-billion dollar industry make for a compelling and attractive investment opportunity.

Figure 17: WEED price performance (CAD)



Source: Bloomberg

Figure 18: SHOP price performance (CAD)



Source: Bloomberg

Similarly, SHOP, which was added to the portfolio in late 2016, has emerged as a leading e-commerce platform for online merchants. Impressive quarterly results, surging customer numbers and a partnership with Amazon Inc has augmented its opportunities all of which should provide further upside for the already successful investment.

Table 1: Top ten holdings, sector breakdown and YTD index returns as 31 October 2017

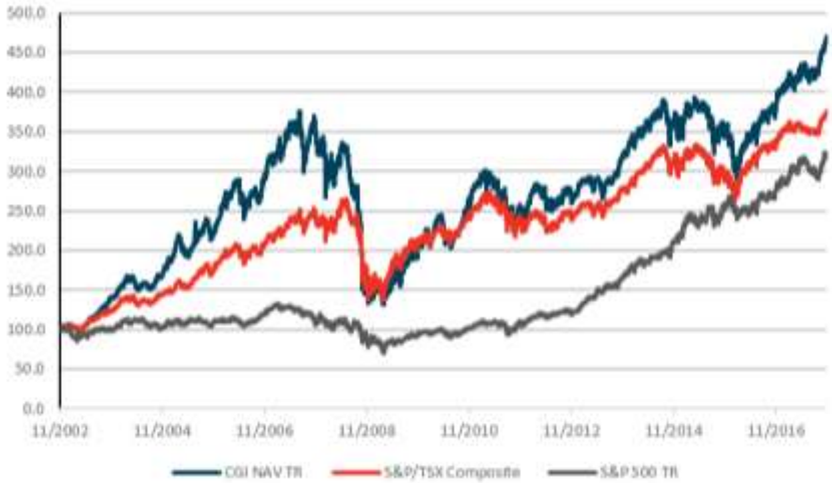
Top ten holdings**	%	Sector breakdown	%	Index returns (CAD)	%
Dollarama Inc	5.8	Materials	20.5	S&P/TSX COMPOSITE	7.3
NVIDIA Corporation	4.9	Consumer Discretionary	16.2	S&P/TSX MATERIALS	4.1
Franco-Nevada Corporation	3.9	Information Technology	15.1	S&P/TSX ENERGY	-7.9
Air Canada	3.5	Financials	13.6	S&P/TSX UTILITIES	11.5
Bank of Montreal	3.4	Energy	13.4	S&P/TSX INDUSTRIALS	18.6
First Quantum Minerals Ltd.	3.3	Industrials	13.3	S&P/TSX TELECOM SERV	13.3
Canadian Pacific Railway Limited	3.1	Telecommunication Services	3.3	S&P/TSX FINANCIALS	12.1
Royal Bank of Canada	3.1	Real Estate	1.1	S&P/TSX CONS STAPLES	3.8
Amazon.com, Inc.	3.1	Utilities	0.9	S&P/TSX CONS DISC	21.3
Open Text Corporation	3.0	Other	1.8	S&P/TSX INFO TECH	16.1
Total	37.2	Cash & cash equivalents	1.0	S&P/TSX REAL ESTATE	8.6

Source: Company data, Bloomberg. Note: **Top ten holdings as at 31 October 2017.

Continue to remain cautious on financials . Also underweight the energy sector

The fund's biggest underweight position continues to be financials because of the impact of low interest rates on the embedded value of the insurers as well as the somewhat overextended nature of the Canadian housing market. The other major underweight sector is in energy, where Eckel continues to believe that the growth of shale oil, particularly in the US, has transformed the market dynamics, capping oil prices for the next few years at the very least.

Figure 19: Canadian General Investments NAV TR vs TSX Composite and S&P 500



Source: Morningstar

While the manager is benchmark aware, the target is to create a portfolio that delivers long-term performance rather than track the benchmark index. Thus, it is only natural that the fund will have periods where the performance diverges significantly from the benchmark index. We note that over the long term the fund has strongly outperformed the benchmark index although some of this is because of the leverage that the fund has deployed.

Table 2: NAV performance of CGI and the TSX Composite Index (%, CAD) as at 22 November 2017

	6 months	1 year	3 years	5 years
Canadian General Investments NAV TR	10.8	19.2	27.8	78.9
S&P/TSX Composite TR	5.3	9.6	16.3	53.5

Source: Morningstar, Stockdale estimates

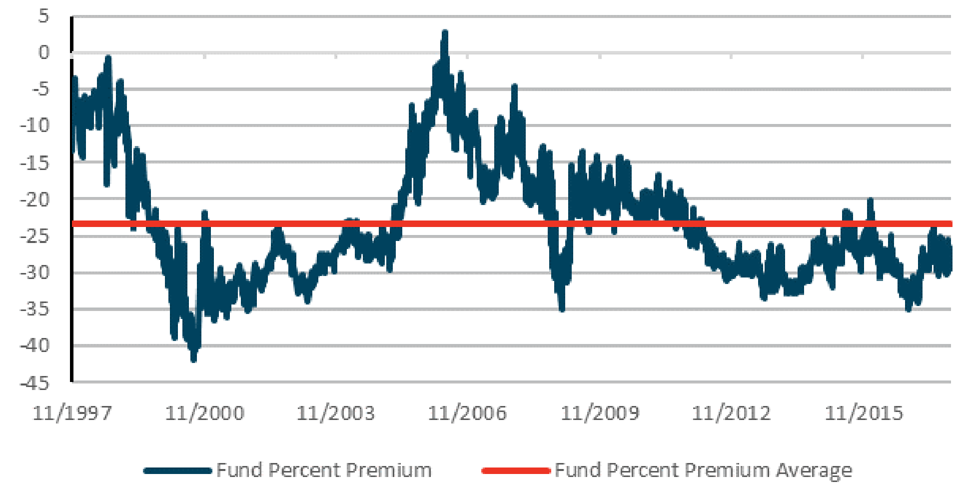
The fund has carried a gross gearing of C$150m via a mix of bank debt and preference shares. The estimated cost of this debt is 3.02% pa. Because of the leverage the historic volatility of CGI's NAV has been significantly higher than both the TSX Index and the S&P 500 Index. However, over the last five years the outperformance has been achieved, while having only slightly higher volatility than the TSX Composite Index.

Discounts and dividends

Trading the discount should provide a source of excess returns. Over the last 20 years the average discount has been 23.4% and we note that over the last 12 months the discount has contracted from c.32% to c.28%, boosting returns by 5.8%. This analysis does not incorporate the dividend yield of 4%; if we include it in our calculations it boosts excess returns to 6.9% over the last 12 months.

The current discount of c.28% still represents an attractive opportunity over the medium term, in our opinion. Looking at the persistence of discounts we note that discounts wider that 30% seldom persist for more than 12 months. We note that there have been periods in the past when CGI has traded at a substantially tighter discount.

Figure 20: CGI – historic discount (%)



Source: Bloomberg

Estimated dividend yield of c.3.3%

We believe that the change in the fund's dividend policy, whereby CGI now intends to pay steady quarterly dividends with less of an emphasis on the special final dividend, may help attract a new category of investors looking for a combination of long-term growth and steady dividend income. The historic dividend yield of c.3.3% should be attractive to investors.

One of the key discount management tools used by most funds, a buy back or tender offer, is not a possibility for CGI given the fund's Investment Corp status. This eliminates a layer of taxation, with capital gains only being taxed at the shareholder level. In addition, it allows the payment of capital gains dividends to shareholders and reduces the rate of tax on investment income. As at 31 October 2017, Jonathan A. Morgan and Vanessa L. Morgan beneficially owned directly or indirectly or exercised control or direction over an aggregate of 10,954,269 shares, representing 52.51% of the outstanding common shares of the company. This implies that a buy-back of even a single share by the company or related parties would trigger the loss of CGI's Investment Corp status.

We note that during periods when there was strong demand for the Canadian equity market the discount at which the fund traded contracted substantially and at various points in time the fund traded at a premium to NAV.

Conclusion

We believe that CGI offers investors a broad-based exposure to the Canadian equity market. The long-term performance of the fund is attractive and it has outperformed both the S&P/TSX Composite Index and the S&P 500 Index over the long-term. Equally its risk profile is similar to the broader index although given the bottom up stock selection methodology used by the manager, we are likely to get significant divergence in performance at various points in time.

As we highlight in our performance chart (Figure 19), the long-term NAV performance of CGI compares favourably not only with the TSX Composite Index but also the S&P 500. Thus, investors looking to diversify their US exposure could use this vehicle to increase their developed market exposure.

Given the controlling stake that Morgan Meighan and related parties have in the fund it is unlikely that the discount will disappear because of corporate action. However, in our view the discount is excessive given the long-term performance of the fund, the dividend policy adopted by the fund and the alignment of long-term interest of the controlling interest and the minority shareholders.

The estimated dividend of 76 cents per share for 2017 is an attractive part of the investment proposition. Dividends can be paid out of income and/or capital gains. In addition, unlike US funds there is no obligation to distribute capital gains in the same year in which it is realised. With a large reserve of unrealised capital gains, we believe that the dividend is relatively secure.

We believe that investors looking to increase their exposure to North American equity markets should buy CGI for long-term performance and a high dividend income.

Table 3: CGI - fund structure (data as at 31 October 2017)

Shares in issue	20.9m
Manager	Morgan Meighen & Associates
Annual management fee	1% of gross assets
Performance fee	None
Management expense ratio	1.65% excluding cost of leverage
Gearing	C$150m split between bank debt and preference shares
Estimated ongoing cost of gearing	3.02% per annum
Historic dividend yield (76 cents in 2016)	3.3%
Frequency of dividend payments	Quarterly
Year-end	December
Website	www.mmainvestments.com
Bloomberg tickers	CGI CN and CGI LN
Sedol	0170710 GB
ISIN	CA1358251074

Source: Company data

Key risks

The principal risks associated with CGI

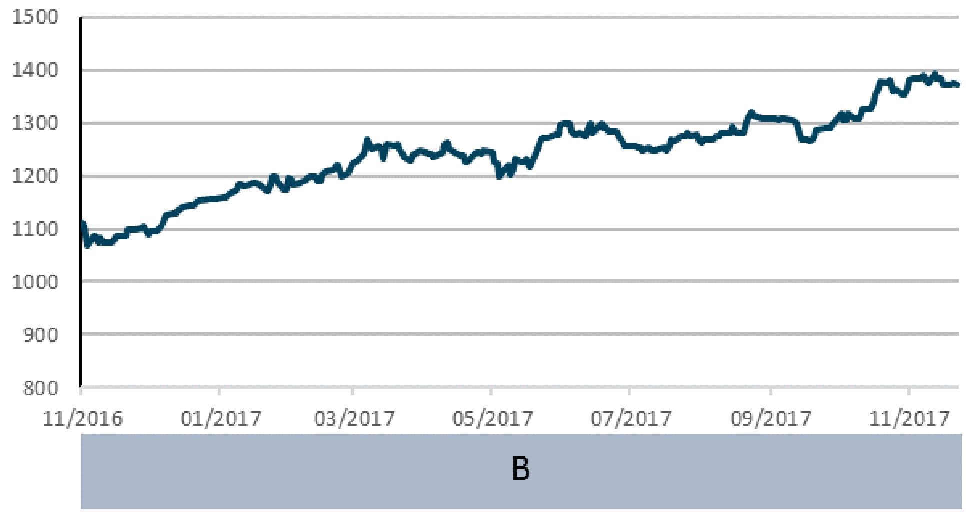
Key asset class risks include

- The housing market is overheated in cities like Vancouver and Toronto
- Commodity prices may fall if emerging markets growth moderates
- Shale oil emergence may threaten the further development of Canadian oil sands
- Stock-specific risk
- Strategy or sector-specific risks

Key fund risks

- Premium/discount of CGI may be volatile
- The trust has substantial active bets and the performance will under most periods differ from the benchmark index

Figure 21: Share price & recommendation tracker graph



Source: Bloomberg, Stockdale Securities

Investment Funds research disclosures

Explanation of Investment Funds recommendations

Stockdale Securities Limited uses a three-tier system for its investment funds recommendations. Investors should carefully read the definitions of all ratings used in each research report. In addition, since the research report contains more complete information concerning the analyst's views, investors should carefully read the entire research report and not infer its contents from the rating alone. In any case, ratings (or research) should not be used or relied upon as investment advice. An investor's decision to buy or sell a stock or investment fund should depend on individual circumstances (such as the investor's existing holdings) and other considerations.

Investment funds ratings are explained as follows:

BUY: Total returns expected to be in excess of those from the fund's benchmark

HOLD: Total returns expected to be in line with those from the fund's benchmark

SELL: Total returns expected to be lower than those from the fund's benchmark

Total return is defined as the movement in the share price over the medium- to long-term, and includes any dividends paid.

Distribution of Stockdale Securities' investment funds recommendations:

Stockdale Securities must disclose in each research report the percentage of all investment funds rated by the member to which the member would assign a "BUY", "HOLD" or "SELL" rating, and also the proportion of relevant investments in each category issued by the issuers to which the firm supplied investment banking services during the previous 12 months. The said ratings are updated on a quarterly basis. This recommendation system differs from the recommendation system used on non-Investment Fund research.

Investment Funds recommendation proportions in last quarter

	BUY	HOLD	SELL
Funds to which Stockdale has supplied investment banking services	100%	0%	0%

Source: Stockdale

The company has seen this research but no material changes have been made as a result.

Stockdale acts as broker or advisor to this company.

Stockdale acts as a market maker or liquidity provider for this company.

Somers Limited is the substantial shareholder (75%) of Stockdale Securities Limited. Utilico Emerging Markets Limited and Somers Limited both have a significant common shareholder, UIL Limited.

Analysts' remuneration is based on a number of factors, including the overall results of Stockdale Securities, to which a contribution is made by investment banking activities. Analysts' remuneration is not based on expressing a specific view or recommendation on an issuer, security or industry.

This research is classified as being a "marketing communication" as defined by the FCA's Handbook. This is principally because analysts at Stockdale Securities are involved in investment banking activities and pitches for new business and consequently this research has not been prepared in accordance with legal requirements designed to promote the independence of investment research. Therefore, the research is not subject to any prohibition on dealing ahead of the dissemination of investment research. Nevertheless, the Firm's Conflict of Interest Management Policy prohibits dealing ahead of research, except in the normal course of market making and to satisfy unsolicited client orders. Please refer to www.stockdalesecurities.com for a summary of our conflict of interest management policy in relation to research. This includes organisational controls (departmental structure, a Chinese wall between corporate finance and other departments, etc), procedures on the supervision and remuneration of analysts, a prohibition on analysts receiving inducements for favourable research, editorial controls and review procedures over research recommendations and a prohibition on analysts undertaking personal account dealings in companies covered by them.

Stockdale Securities, Beaufort House, 15 St. Botolph Street, London EC3A 7BB **Email: firstname.surname@stockdalesecurities.com**

Investment Funds Contacts

IF Sales/Market Making		**IF Research**	
Matthew Kinkead	+44 (0)20 7601 6626	Saumya Banerjee	+44 (0)20 7601 6629
Darren Papper	+44 (0)20 7601 6632	**IF Corporate Finance**	
Calum Summers	+44 (0)20 7601 6631	Robert Finlay	+44 (0)20 7601 6115
Pauline Tribe	+44 (0)20 7601 6623	Owen Matthews	+44 (0)20 7601 6118
		Rose Ramsden	+44 (0)20 7601 6110