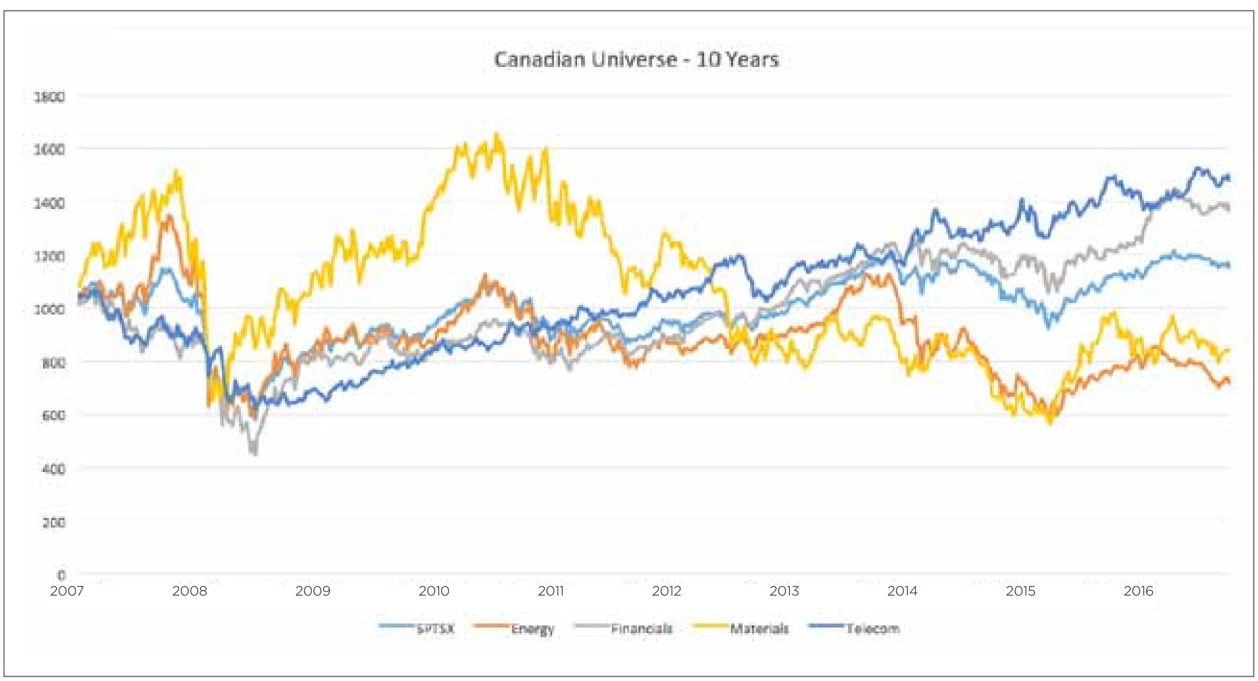
Oh, Canada! What is Happening?

Gary Perron, CFA, Portfolio Manager, Founder

Canadian investing has been a challenge these last 10 years, with the Canadian TSX Composite Index up 1% on growth and 3% with dividends.

The charts below clearly identify that the sectors of outperformance have been the two cartels, Financials (Banks) and Telecom, while the other Canadian sectors have been very challenging with cyclicality (commodity) behaviour. The Energy and Material sectors have seen wealth destruction for this 10-year period, with lower commodity prices and major political and regulatory headwinds.

The universe of viable Canadian businesses continues to shrink. The TSX composite index has gone from 300 names to now 250 names, with six healthcare names and 12 Technology names. The concern is that most of the names are not commercially investable, and so Perron & Partners' universe of Canadian investable companies continues to shrink.



Source: Bloomberg L.P. (2017). SPTSX Index Last Ten Years. Retrieved September 6, 2017 from Bloomberg terminal.

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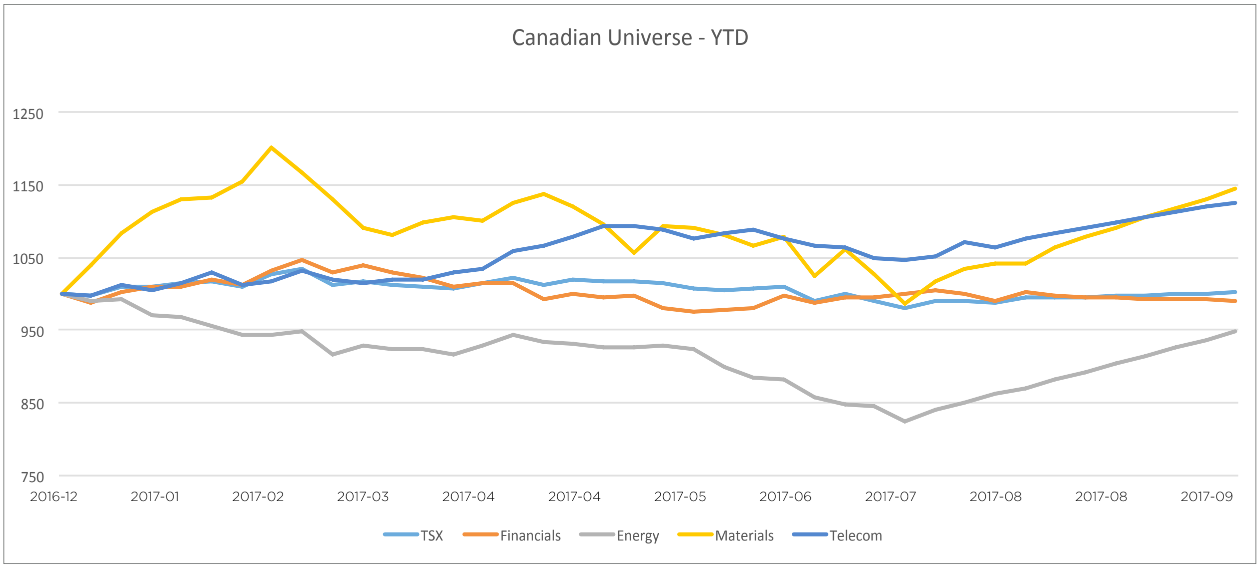

Source: Bloomberg L.P. (2017). SPTSX Index YTD. Retrieved September 6, 2017 from Bloomberg terminal.

The reality now is that we have socialist political parties running the country on both a provincial and federal level, who are not friendly to businesses, capitalists or entrepreneurs!

Unfortunately Canada is one of the highest taxed countries in the competitive world, which makes it more difficult to generate shareholder returns on an after-tax basis.

Higher corporate tax rates diminish the value of public and private companies for shareholders. Foreign and domestic capital is leaving Canada in search of jurisdictions that are more friendly for shareholders. Perron & Partners currently has a high proportion of foreign holdings in our portfolios and will continue to increase those foreign holdings.

The one area of opportunity in Canada is obviously the cyclical stocks (Energy, Materials, agricultural and forest products).

All commodities have a cycle where demand outstrips supply at some point, and the commodity price rises to encourage investors with better economics to invest capital in order to bring on new supply.

The year-to-date returns (chart above) in the cyclicals show major wealth destruction with foreign capital outflows and underperforming commodity prices. I have copied some comments from a Raymond James article below – one of the few recent energy outlook presentations that reflects my opinion that gas is oversupplied and oil is about to go on a run.

Bottlenecks, Banks & Roughnecks:

Energy companies have delayed long-term projects and are struggling even to meet their interest payments. According to Raymond James, "1 out of the 50 producers included in their US research coverage is Free Cash Flow Positive at $48 per barrel of oil equivalent

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this year. Producers are on track to outspend cash flow by 60% this year...something has to give.[1]" The riggers have already moved back to Newfoundland, the baby boomers are fed up with this cyclical industry and there is also potential for a labour shortage.

Waiting for the Knife to Drop:

We can't call this the bottom for certain, but the trend is clear; global demand for oil has grown unabated and all it will take is one supply catalyst. Given the cut on OPEC budgets in the past few years, there is a much greater sensitivity (if demand goes up and the US can't meet it!).

> The only way that we can get to 1.5M bpd of production growth in the US is if oil is at $65 and we go to 1,100 rigs. At $50 oil, we are at 700 rigs **and no production growth.**[2]

Obviously the Energy sector has been in one of the worst cycles that I've witnessed over my career, but this cycle has dropped business valuations of producers and service companies to extremely low levels. We can buy services companies well below book value (their cost of acquiring the equipment) and low price/cash flow multiples. In fact some of these service companies are starting to generate free cash flow, which will be used to pay down debt and initiate dividends at some point. Energy producers are trading at very low business metrics relative to the past cycles, and none have any potential commodity price increases built into their current public market values. This definitely is an opportunity, but timing is very critical. We have been too early with some of our investments in the energy space, though now is not the time to exclude energy from the portfolios.

> OPEC Spare Capacity - "There is no room for error." Outside of Iran and the UAE... OPEC production cannot meaningfully grow;[3]

Now let's review US and international investment opportunities.

The largest pension fund in Canada (CPP Investment Board[4]), proportion of public equity investments is 94% invested outside of Canada – yes, 94% invested outside of Canada.[5] What message does that send? Brookfield Asset Management is the largest public investment manager in Canada, and they are 90% invested outside of Canada.

The charts on page five and six reflect the investment returns for the last ten years.

> Year-to-date, in the USA, Healthcare and Technology have returned 12% and 16%, respectively, and will probably produce similar returns in the future.

[1] Raymond James
[2] Ibid.
[3] Ibid.
[4] Condensed Interim Consolidated Financial Statements of Canada Pension Plan Investment Board as of June 30, 2017
[5] Brookfield asset management data. 2016 ANNUAL REPORT Brookfield Asset Management Inc., Page 2

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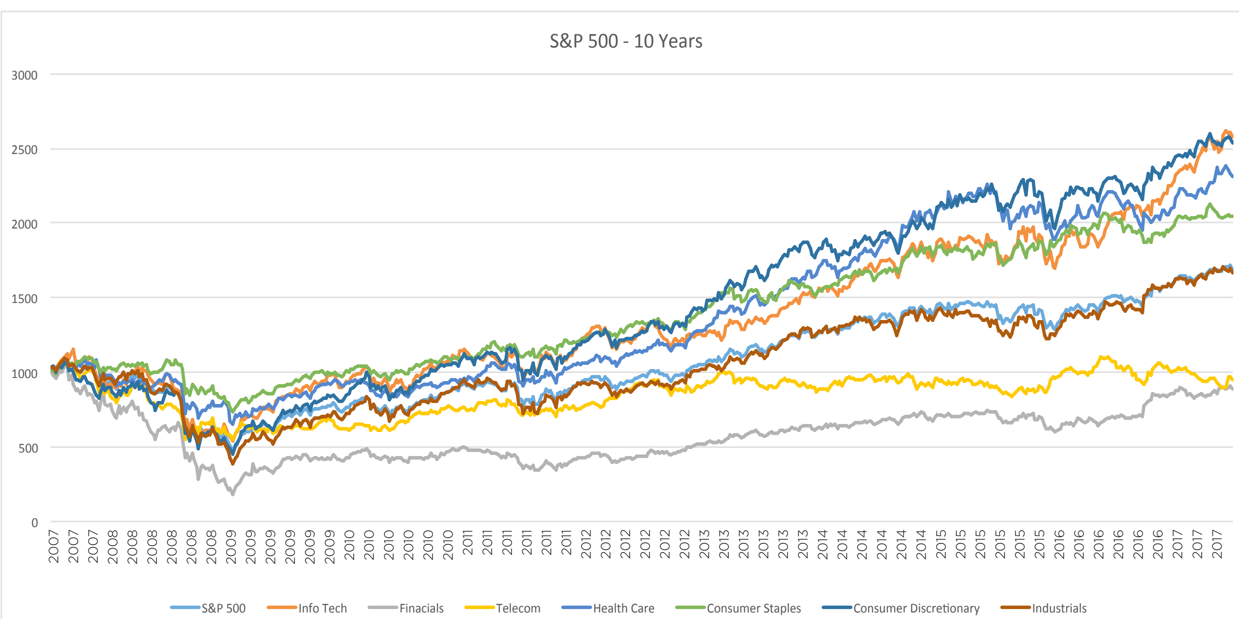
Our Kipling funds have participated in both sectors since inception, and Perron & Partners will continue to invest resources and money to further our strength and knowledge in these sectors. The only US sector to underperform year-to-date has been the Telecom sector, which is highly competitive with declining consumer prices and narrowing profit margins. This is different from the Canadian Telecom cartel (three companies). Cell phone costs for consumers are substantially less in the US than in Canada.

Perron & Partners' focus will be to continue to expand our investment strengths into the international and US arena of companies.

There is no doubt that the investment climate is very attractive outside Canada, which is rather concerning as a Canadian looking into the future, for our next generation.

Our **Kipling Global Enhanced Dividend Fund** will celebrate the end of its third year this October. The fund currently is 60% invested outside of Canada and will continue to expose fund investors to international businesses. The Kipling Global Enhanced Dividend Fund has an emphasis on companies (including Canada) that exhibited strong profitability, balanced sheet flexibility and a commitment to continue to grow their dividends. 88% of the long positions have increased their dividend in the last 12 months with the Top 10 positions having increased their payout by an average of 10%. While Canada has world class companies in the Energy, Telecommunications and Financials Sectors, it lacks depth in some critical areas such as Industrials, Technology, Discretionary and Health Care. Concequently, the Kipling Global Enhanced Dividend Fund provides Geographic and Sector diversification beyond the Canadian boarders (Canada 46%, US 35%, Europe 17%, AsiaPac 2%). Since



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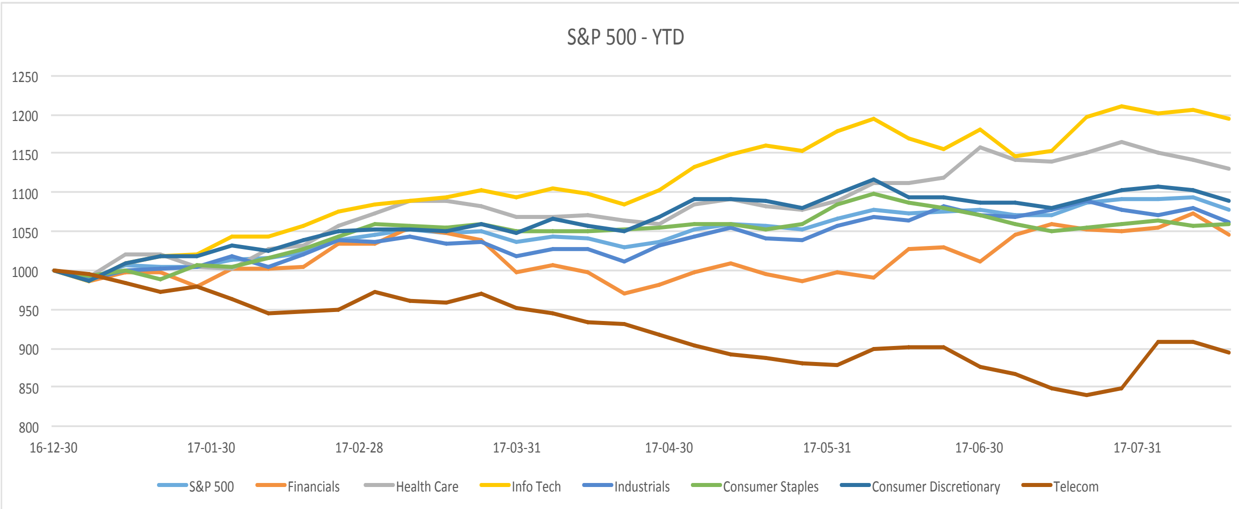

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inception (Oct 2014 to Sept 30, 2017) the enhanced strategy generated a return of 8.5%, while significantly reducing the downside risk (maximum drawdown over the same time frame is 7.5% vs. 12.0%).

Our Kipling US Enhanced Equity fund celebrated its third year this September, and has annualized returns of 8.8% in Canadian dollar terms.

While the Kipling Global Enhanced Dividend Fund invests in companies that consistently grow their dividend, the Kipling US Enhanced Equity Fund compliments this approach by investing in companies that are experiencing high rates of operational growth, as described further in our article "Investing in the Technology Sector in 2017". Given an abundance of high growth rate projects in which to invest, these companies tend to reinvest in their business rather than pay dividends. We are responding to the need of our clients to increase exposure to global equity markets by expanding the investable universe of the Kipling US Enhanced Equity Fund to include global equities. To accurately reflect this adjustment, the name of the fund will be changed to the **Kipling Global Enhanced Growth Fund** and its benchmark going forward will be the iShares MSCI World index. The iShares MSCI World index is approximately 40% invested in developed markets outside of North America, enabling the Fund to invest in a greater number of high quality growth companies. Please note that the quarterly distribution that the fund currently pays will remain unchanged.

This newsletter edition covers topics of war and peace and their effects on the marketplace, a commentary on the technology space, and some family transition planning advice on using trusts. Enjoy the colors of the fall and the outdoors, and please call us with any questions.

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