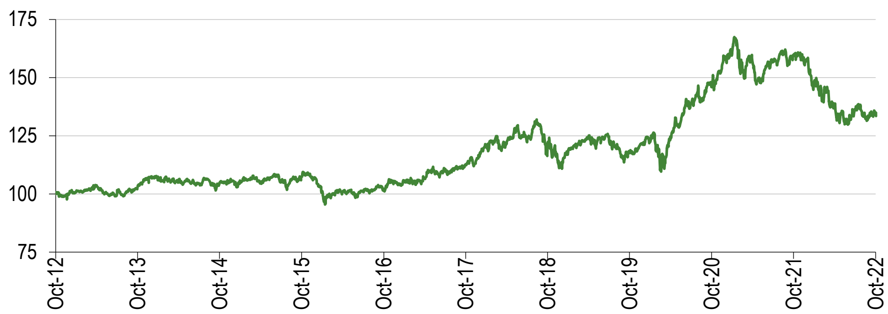
Canadian General Investments

Recent performance affected by top-down events

Investment companies
North American equities

Canadian General Investments (CGI) is managed by Greg Eckel at Morgan Meighen & Associates (MMA). He explains that in 2022, the stock market has been driven by macroeconomic events and investors have essentially ignored company fundamentals, which are the long-term drivers of share prices. The manager is sticking to his principles and continuing to focus on stock selection – a strategy that has led to a very commendable long-term record of outperformance. Eckel believes that stock market volatility is likely to persist as central banks need to further tighten monetary policy to combat higher inflation; he does not anticipate a repeat of the V-shaped market recovery seen during the COVID-19 pandemic. If the macroeconomic backdrop improves, the manager expects quality companies to outperform, so for now he is 'weathering the storm' and looking forward to sunnier times.

Long-term NAV outperformance versus benchmark but tricky 2022 to date



Source: Refinitiv, Edison Investment Research

The analyst's view

While investors hope that central banks are close to the end of their interest rate tightening cycles and the economic impacts of higher rates are modest, the macroeconomic environment is very uncertain and is yet to be fully reflected in corporate earnings. Hence, further stock market volatility is likely, and investors could benefit from considering a carefully managed portfolio of high-quality businesses that are held for the long term. CGI has certainly proved its credentials as data from MMA show that over the last 50 years to the end of 2021, the fund generated an annual share price total return of +12.1%, versus the benchmark's +9.6% annual total return. A C$100k investment, with dividends reinvested, would have grown to c C$30.2m over this period.

Discount wider than historical averages

In an environment of heightened investor risk aversion, CGI's 33.7% discount is wider than the 29.9% to 31.7% range of average discounts over the last one, three, five and 10 years. The company pays regular quarterly dividends, and its annual distribution grows steadily (+4.5% in respect of FY22). Based on its current share price, CGI offers a 2.7% dividend yield.

15 November 2022

Price		**C$33.56**
Market cap		**C$700m**
AUM		**C$1,206m**
NAV*		C$50.62
Discount to NAV		33.7%

*Including income. At 14 November 2022.

Yield		2.7%
Ordinary shares in issue		20.9m
Code/ISIN		CGI/CA1358251074
Primary exchange		TSX
Secondary exchange		LSE
AIC sector		North America
52-week high/low	C$45.00	C$28.85
NAV* high/low	C$63.67	C$44.65

*Including income

Gross gearing*	14.8%
Net gearing*	14.1%

*At 31 October 2022.

Fund objective

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. CGI's performance is measured against the S&P/TSX Composite Index.

Bull points

- Diversified portfolio of North American equities.
- Very long-term record of outperformance versus the benchmark.
- Rising regular quarterly dividends.

Bear points

- Discount remains consistently wide.
- High level of family ownership.
- The relatively high level of gearing will amplify capital losses during a market sell-off.

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Market outlook: Tighter monetary policy

While the Canadian stock market sector leadership has started to broaden out, as at end-October 2022, there were three sectors in positive territory this year; energy really has been 'the only game in town' (Exhibit 1). Investors have had to navigate a tricky macroeconomic backdrop characterised by higher inflation and rising interest rates, while shifting expectations about the pace of tighter US monetary policy have caused very sharp short-term moves in share prices. In Canada, the base interest rate has increased from 0.25% to 3.75% and more hikes are anticipated as the central bank seeks to combat higher prices.

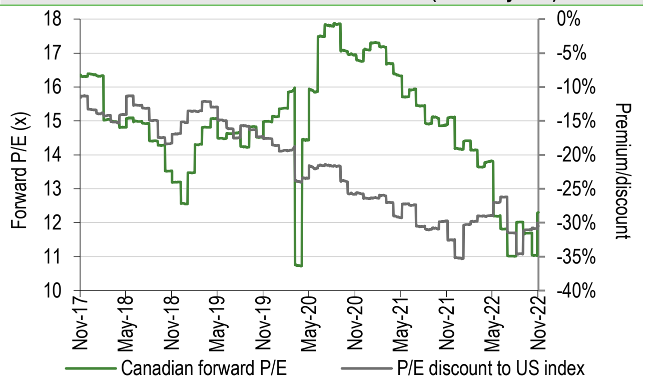
While Canada can be overlooked by global investors, it has some favourable attributes that may warrant attention. The International Monetary Fund's GDP growth forecasts are meaningfully higher for Canada compared with the United States (3.3% versus 1.6% for 2022 and 1.5% versus 1.0% for 2023). Also, Canadian stocks remain relatively attractively valued with the Datastream Canada Index trading on a 12.3x forward P/E multiple, which is a 30.5% discount to the Datastream US Index. This margin is much wider than the 21.9% five-year and 14.3% 10-year average discounts. While financials and energy make up around half of the bellwether S&P/TSX Composite Index, they contain less than 30% of the index constituents.

Exhibit 1: S&P/TSX Composite Index data and valuation

S&P/TSX Composite Index data (at 31 October 2022)

	Number of companies	Weight (%)	10M22 total return (%)	2021 total return (%)
Financials	29	30.6	(9.6)	36.6
Energy	38	19.1	36.7	49.0
Industrials	27	13.3	1.1	16.5
Materials	51	11.3	(6.6)	4.1
Info technology	14	5.6	(52.8)	18.5
Comm'n services	7	4.9	(3.7)	24.7
Utilities	16	4.7	(5.7)	11.7
Consumer staples	11	4.1	7.1	22.4
Cons discretionary	14	3.6	(6.6)	18.5
Real estate	22	2.5	(24.6)	37.5
Healthcare	7	0.4	(53.8)	(19.6)
Index	**236**	**100**	**(6.1)**	**25.2**

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. Valuation data at 14 November 2022.

The fund manager: Greg Eckel

The manager's view: More interest rate hikes to come

Eckel comments that 'we are all facing the same demons' with higher inflation and rising interest rates, while the war in Ukraine is affecting commodity prices, especially in the oil complex. The manager reports that the Canadian economy is benefiting from higher energy prices, but these are eating into corporate margins and leading to higher interest rates. While the Canadian Consumer Price Index has moderated from 8.1% in June to 6.9% in September, the Bank of Canada and the US Federal Reserve will continue to increase interest rates, seeking to combat higher prices. In October 2022, the Canadian base rate was increased by a further 50bp to 3.75%, which was less aggressive than the consensus forecast for a 75bp increase. The manager says that food price inflation is running at a low double-digit rate, but gasoline prices have moderated from their peaks. In Canada, the labour market is tight, and the unemployment rate has declined from 5.4% to 5.2%. However, Eckel notes there are signs of softening in the Canadian housing market as sales have declined but pricing is sticky, although the rental market is very tight, which is adding to inflation. He suggests that given the lag between raising interest rates and the impact on the economy there is a risk that the central bank overshoots and causes a recession; currently the consensus is for a terminal base rate of 4.25–4.50%. On a brighter note, however, Eckel highlights that the Canadian economy is 'coming from a good place' given the country's commodity exposure and the fact that consumers built up their savings during the pandemic; albeit part of which has since been spent. The manager opines that while we 'could be on a tightening interest rate journey for a while, we are likely to be closer to the end than the beginning'. He comments that so far there has not been a significant increase in the number of corporate profit warnings and while there is talk of a recession this is not yet evident. However, Eckel is expecting a greater number of downgrades as over the last two earnings seasons some companies have highlighted labour and supply chain constraints. As an example, recreational vehicle manufacturer BRP was building units and shipping them to dealerships but was then having to install semiconductor components later when they became available. The manager comments that, so far, demand within the economy has generally held up well but 'inflation is starting to bite', especially as mortgage rates are rising.

Current portfolio positioning

At end-October 2022, CGI's top 10 positions made up 37.5% of the fund, which was not dissimilar to 38.1% 12 months earlier; seven positions were common to both periods.

Exhibit 2: Top 10 holdings (at 31 October 2022)

			Portfolio weight %	
Company	**Country**	**Industry**	**31 October 2022**	**31 October 2021***
Canadian Pacific Railway	Canada	Railroads	5.0	3.8
West Fraser Timber	Canada	Forest products	4.5	3.4
Franco-Nevada Corp	Canada	Gold mining	4.2	3.5
Apple	US	Technology	3.8	N/A
TFI International	Canada	Transport & logistics	3.7	3.3
First Quantum Minerals	Canada	Metals & mining	3.7	3.6
WSP Global	Canada	Business services	3.4	2.7
The Descartes Systems Group	Canada	Logistics software	3.2	2.8
Mastercard	US	Financial transaction processing	3.0	N/A
Bank of Montreal	Canada	Banks	3.0	N/A
Top 10 (% of portfolio)			**37.5**	**38.1**

Source: CGI, Edison Investment Research. Note: *N/A where not in end-October 2021 top 10.

Considering CGI's sector exposure, which is shown in Exhibit 3, over the 12 months to end-October 2022, the notable changes are a lower technology weighting (-10.5pp) and a higher allocation to energy stocks (+6.2pp). The fund's structure remains largely unchanged with a large 19.4pp underweight position in financials stocks and overweight exposures to the consumer discretionary (+8.7pp) and industrials (+8.0pp) sectors.

CGI's reduced technology exposure is a mix of share price performance and active selling. Eckel explains that high-multiple, long-duration stocks remain under pressure in an environment of rising interest rates, and semiconductor stocks are facing a headwind from the US restricting higher-end exports to China. While not looking to increase CGI's technology exposure now, the manager anticipates there will be opportunities in the future; it should be remembered that technology stocks were an important positive contributor to the fund's significant outperformance in 2020 and 2021.

Eckel has been underweight energy stocks since 2001 but is more positive on the outlook for the sector than he has been in a long time. This is based on improved industry demand and supply dynamics, and major oil companies are now more disciplined in terms of capital allocation and returning cash to shareholders. However, the energy sector can be volatile; it is not unusual for it to be the best performing of the 11 sectors one year and the worst performing the next. Eckel explains that he increased CGI's energy exposure earlier in 2022 but had to hold off as the sector rallied in response to spiking commodity prices. Within the sector, higher product prices have led to stronger balance sheets, allowing companies to resume dividend payments and undertake share repurchases.

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

	Portfolio end October 2022	Portfolio end October 2021	Change (pp)	Index weight	Active weight vs index (pp)	Fund weight/ index weight (x)
Industrials	21.2	20.9	0.3	13.3	8.0	1.6
Information technology	17.5	28.0	(10.5)	5.6	11.9	3.1
Materials	16.0	16.1	(0.1)	11.3	4.7	1.4
Energy	12.4	6.2	6.2	19.1	(6.7)	0.6
Consumer discretionary	12.3	10.9	1.4	3.6	8.7	3.4
Financials	11.2	10.5	0.7	30.6	(19.4)	0.4
Real estate	5.2	4.1	1.1	2.5	2.8	2.1
Communication services	2.3	1.8	0.5	4.9	(2.6)	0.5
Healthcare	1.1	1.2	(0.1)	0.4	0.7	2.5
Consumer staples	0.0	0.0	0.0	4.1	(4.1)	0.0
Utilities	0.0	0.0	0.0	4.7	(4.7)	0.0
Cash & cash equivalents	0.8	0.3	0.5	0.0	0.8	N/A
	100.0	**100.0**		**100.0**		

Source: CGI, Edison Investment Research. Note: Numbers subject to rounding.

CGI has a new position in Baytex Energy, which is a junior exploration and production company with production guidance of 83–85k barrels of oil equivalent (BOE) per day (83% is oil) growing at around 5% a year. Approximately one-third of Baytex's production comes from the prolific Eagle Ford shale area in Texas and the company has accelerated development in a relatively new play called Clearwater in Canada, which is an area that has been attracting attention due to strong drilling success. Debt reduction has been Baytex's primary focus of utilising free cash flow, but given its stronger balance sheet, attention has now shifted towards higher returns to shareholders via dividends and share repurchases.

Eckel has been adding to CGI's position in Canadian Natural Resources (ticker: CNQ), which is a large-cap oil and natural gas firm with a highly respected management team. The company has a production base of c 1.2m BOE per day that is growing at 7–8% a year. CNQ's production mix is diverse, split broadly: 34% oil sands mining and upgrading (synthetic crude oil, SCO); 28% heavy crude oil; 27% natural gas; and 11% light crude oil and natural gas liquids. The company can upgrade its own heavy oil to SCO, which trades at a premium to the benchmark oil price. CNQ has a long-life reserve base of more than 30 years and has paid down debt, thereby providing flexibility for mergers and acquisitions. The company has been returning cash to shareholders; it has increased its quarterly distributions and paid a special dividend in August 2022, and has also been buying back its shares.

CGI's position in Cargojet was sold. It is the largest overnight cargo operator in Canada and was a pandemic beneficiary. The company has a 90% market share, so is expanding outside of Canada and has made a couple of acquisitions that have not been favoured by investors. Also, airlines are reintroducing flights, so industry capacity is increasing.

Eckel has consolidated CGI's base metals exposure by selling the holdings in Copper Mountain Mining Corporation, Lundin Mining Corporation and Hudbay Minerals. All three companies have growth projects underway, which the manager considers is not ideal given higher financing costs and development risks. Part of the sale proceeds were used to increase CGI's holding in Teck Resources. This company is bringing on new production in Q422, so should reap the benefits of higher cash flow going forward. Teck Resources is returning a meaningful amount of cash to shareholders and its ESG profile is improving as its business mix shifts in favour of copper at the expense of metallurgical coal. The manager considers that the company remains inexpensively valued and he expects its shares to re-rate as he believes that Teck Resources should be the 'go-to' name for base metal exposure.

Performance: This year is somewhat challenging

Exhibit 4: Five-year discrete performance data

12 months ending	Share price (%)	NAV (%)	S&P/TSX Composite (%)	MSCI Canada (%)	MSCI World (%)
31/10/18	2.2	3.1	(3.4)	(3.4)	3.6
31/10/19	8.3	10.6	13.2	12.5	13.4
31/10/20	20.0	21.3	(2.3)	(3.9)	6.4
31/10/21	46.0	51.9	38.8	39.5	31.1
31/10/22	(18.2)	(19.8)	(4.9)	(4.5)	(9.9)

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

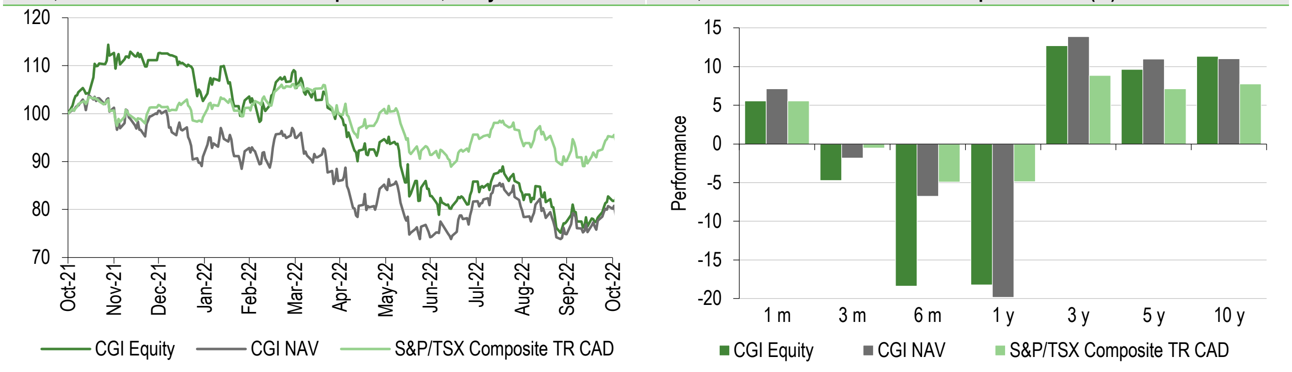
While CGI's absolute and relative performance over the last year has been disappointing, it is important to consider the fund's very commendable long-term record of outperformance.

Data from MMA show that over the 25 years to the end of December 2021, the fund generated a +10.5% annual total return versus the benchmark's +7.9% annual total return; with dividends reinvested, a C$100k investment in CGI would have grown to c C$1.2m.

Over the 50 years to the end of 2021, the fund generated a +12.1% per year annual total return versus the benchmark's +9.6% annual total return; with dividends reinvested, a C$100k investment in CGI would have grown to c C$30.2m.

Exhibit 5: Investment company performance to 31 October 2022

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.

CGI's relative performance is shown in Exhibit 6. While the one-year numbers are disappointing, its NAV total return is meaningfully ahead of that of the S&P/TSX Composite Index over the last three, five and 10 years.

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

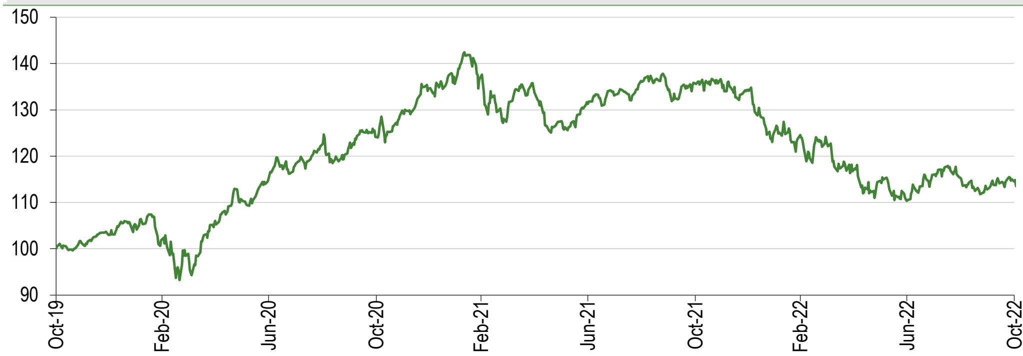
	One month	Three months	Six months	One year	Three years	Five years	10 years
Price relative to S&P/TSX Composite	0.0	(4.2)	(14.2)	(14.0)	11.0	12.4	38.5
NAV relative to S&P/TSX Composite	1.5	(1.3)	(1.9)	(15.7)	14.5	19.4	34.6
Price relative to MSCI Canada	(0.3)	(4.5)	(14.6)	(14.3)	11.8	13.9	38.3
NAV relative to MSCI Canada	1.2	(1.6)	(2.4)	(16.0)	15.3	21.0	34.4
Price relative to MSCI World	(0.8)	(4.1)	(17.0)	(9.3)	13.8	7.2	(13.7)
NAV relative to MSCI World	0.6	(1.1)	(5.2)	(11.1)	17.4	13.9	(16.1)

Source: Refinitiv, Edison Investment Research. Note: Data to end-October 2022. Geometric calculation.

Eckel explains that CGI's performance this year has been hurt by its underweight energy and overweight technology exposures. The manager also expresses his frustration about share prices declining despite company fundamentals remaining robust; he explains that investors have been selling lower-quality names and have progressed to disposing of higher-quality businesses. Eckel highlights CGI's meaningful outperformance in 2020 and 2021 and considers 2022 'a bit of a reversion to the mean'. He comments that around a quarter of the shares of CGI's portfolio companies are in positive territory this year, which is broadly in line with the market, but unfortunately these companies do not make up a large enough part of the fund.

Positive contributors to CGI's performance this year include Baytex Energy (oil and gas production), Dollarama (low-end retail), Teck Resources (copper, zinc and metallurgical coal mining) and Waste Connections (waste management). Detractors to the fund's performance are a diverse mix including BRP (recreational products), Boyd Group Services (collision repair centres), FirstService Corp (real estate management), goeasy (alternative financial services) and WSP Global (professional services). Eckel stresses the need to 'keep the faith' in high-quality names in the portfolio during periods of share price weakness.

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



Source: Refinitiv, Edison Investment Research

Peer group comparison

Exhibit 8: Selected peer group at 14 November 2022 (C$)*

% unless stated	Market cap (C$m)	NAV TR one year	NAV TR three year	NAV TR five year	NAV TR 10 year	Discount (cum-fair)	Ongoing charge	Perf. fee	Net gearing	Dividend yield
Canadian General Investments	700.1	(17.4)	51.3	75.4	205.8	(33.7)	1.4	No	114	2.7
Middlefield Canadian Income	208.5	(0.1)	31.1	47.4	126.0	(10.2)	1.2	No	118	4.0
Average	**454.3**	**(8.7)**	**41.2**	**61.4**	**165.9**	**(21.9)**	**1.3**		**116**	**3.4**
Fund rank in sector	**1**	**2**	**1**	**1**	**1**	**2**	**1**		**2**	**2**

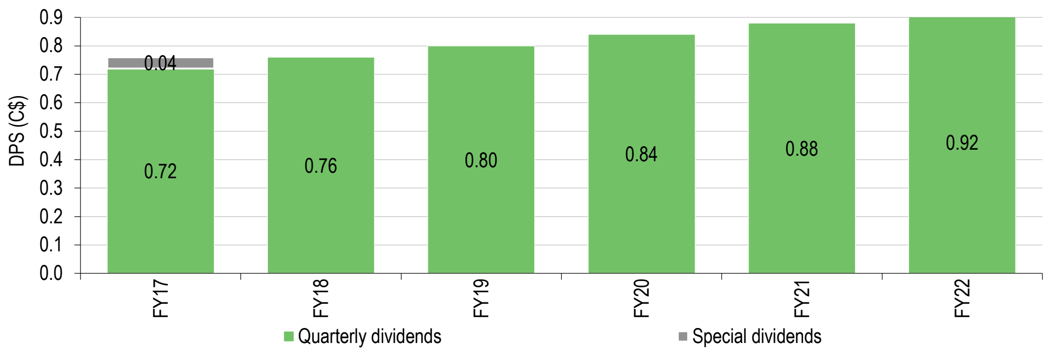
Source: Morningstar, Edison Investment Research. Note: *Performance to 11 November 2022 based on ex-par NAV. TR = total return. Net gearing is total assets less cash and equivalents as a percentage of net assets.

There are just two funds in the AIC North America sector with significant Canadian exposure and CGI is by far the largest. The two companies follow different investment mandates – CGI has a total-return focus, while, as its name suggests, Middlefield Canadian Income has an income bias. Both funds have an allocation to US equities, but CGI's is larger at c 20% compared with c 5% at Middlefield Canadian Income. CGI has a lower NAV total return over the last 12 months but has significantly outperformed its peer over the last three, five and 10 years. It has a lower level of gearing and the fund's discount is considerably wider, perhaps reflecting its limited free float. CGI has a higher fee structure and a lower dividend yield, which is unsurprising given focus on total-return rather than income.

Dividends: Steadily growing annual payments

Regular quarterly dividends are paid in March, June, September and December, and as shown in Exhibit 9, no special dividends have been paid since FY17. The C$0.92 per share annual dividend declared in respect of FY22 is made up of four regular taxable dividends of C$0.23 per share and is 4.5% higher than the $0.88 per share FY21 annual dividend (made up of two regular taxable dividends and two capital gains dividends of C$0.22 per share). Based on its current share price, CGI offers a 2.7% dividend yield.

Exhibit 9: Dividend history since FY15

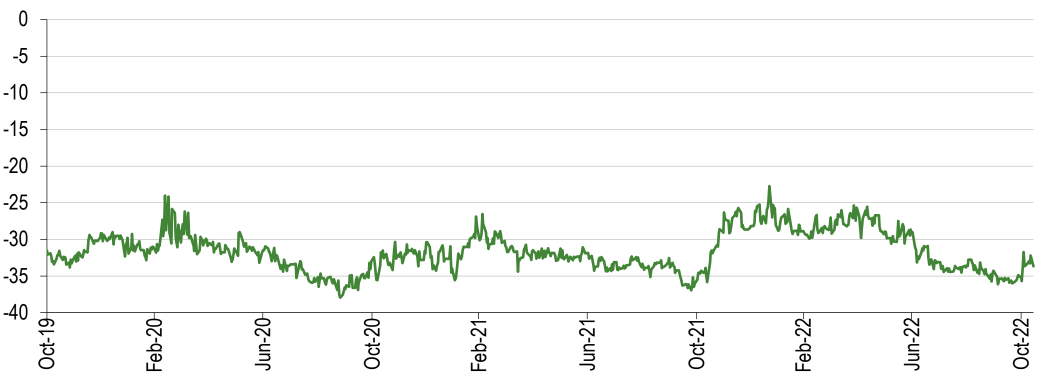


Source: Bloomberg, Edison Investment Research

Valuation: Discount affected by higher risk aversion

CGI's 33.7% share price discount to NAV is towards the wider end of the 22.7% to 36.1% range of discounts over the last 12 months. It is also wider than the 30.4%, 31.7%, 31.0% and 29.9% average discounts over the last one, three, five and 10 years, respectively. This is unsurprising given a heightened level of investor risk aversion due to the uncertain macroeconomic environment.

Exhibit 10: Share price discount to NAV (including income) over three years (%)



Source: Refinitiv, Edison Investment Research

The board is unable to repurchase shares to help manage the discount as this would invalidate the company's favourable Canadian investment corporation tax status. There have been brief periods when CGI's shares traded at a premium to NAV; the last time was in 1998, while they traded very close to par in 2006, a period when CGI outperformed its benchmark and there was a commodities super-cycle and rising oil price.

Fund profile: North American equity specialist

CGI was established in 1930 and is North America's second-oldest closed-end fund. It has been listed on the Toronto Stock Exchange since 1962 and on the London Stock Exchange since 1995. MMA took over management of CGI in 1956; the firm has c C$2.5bn of assets under management for both private and institutional clients. Eckel has managed CGI's portfolio since 2009, aiming to generate a better-than-average total return from a diversified portfolio of North American equities via prudent stock selection and timely recognition of capital gains and losses. While most of the fund is invested in Canadian companies, up to 25% may be held in US-listed businesses. The manager has an unconstrained approach, within the remit that a maximum 35% of the portfolio may be held in a single sector and he invests without reference to the sector weightings of its benchmark, meaning CGI's performance may differ meaningfully from that of the S&P/TSX Composite Index. Eckel has a medium- to long-term view, so some of the fund's holdings have been in the portfolio for many years.

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, allowing them to be paid as dividends to shareholders. However, to maintain this favourable tax status, CGI 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.

Investment process: Bottom-up stock selection

Eckel's stock selection process is primarily bottom up, although he does take the macroeconomic environment into account. The manager aims to generate an above-average total return for investors, seeking reasonably valued companies with favourable fundamentals and strong management teams; he also takes firms' economic social and governance credentials into account. While most of CGI's portfolio is invested in Canadian companies, up to 25% of the fund may be held in US equities, which are primarily in niche operations or business areas that are under-represented in the Canadian market. The broad exposures at the end of October 2022 were 80% Canada, 19% US and 1% cash/equivalents.

There are 56 holdings in the portfolio with a bias to large- and mid-sized stocks. Some of these are higher yielding, such as the Canadian banks, helping to support CGI's own dividend payments. Eckel has a long-term focus; over the last five financial years, portfolio turnover has averaged c 7.4% pa (range of 2.3–10.4%), which implies a c 13.5-year average holding period. However, positions are reassessed regularly to ensure they are sized correctly and investment cases are still valid. The manager has a history of successively backing good management teams that may move companies due to mergers and acquisitions.

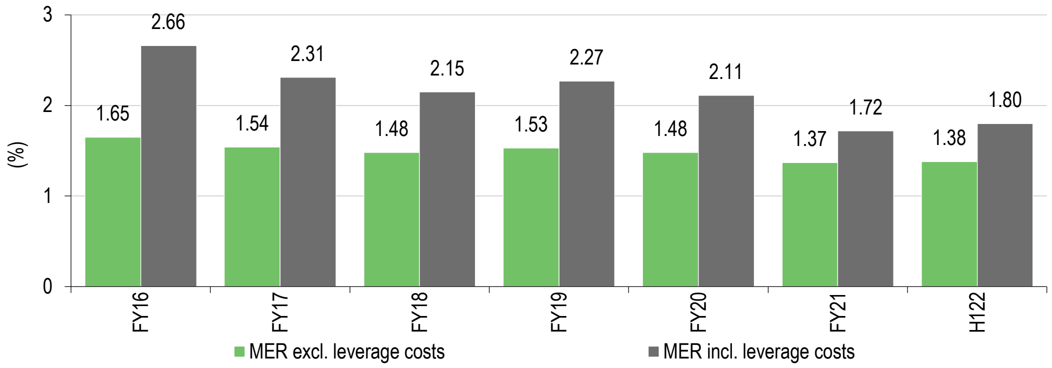
Gearing: Preference shares and margin borrowing

CGI has employed a leveraged strategy since its first issue of preference shares in 1998. Since then, its total return has averaged 6.24% per year above its cost of debt. The company has a C$100m margin borrowing facility via a prime brokerage services agreement with a Canadian chartered bank, at a one-month Canadian dollar offer interest rate plus 0.6% per year (C$75m is being used). CGI also has C$75m of 3.75% cumulative Series 4 preference shares, which are redeemable, at par, on or after 15 June 2023. At end-October 2022, CGI's net gearing was 14.1%.

Fees and charges

MMA is paid a management fee that is calculated and paid monthly at 1.0% per year of the market value of CGI's investments, adjusted for cash, portfolio accounts receivable and portfolio accounts payable; no performance fee is payable. In H122, the annualised management expense ratio (MER) including leverage costs was 1.80%, which was 8bp higher than 1.72% in FY21. Excluding leverage costs, which make the MER more comparable with the ongoing charge figure used in the UK, in H122 it was 1.38%, which was broadly in line with 1.37% in FY21.

Exhibit 11: Management expense ratio since FY16

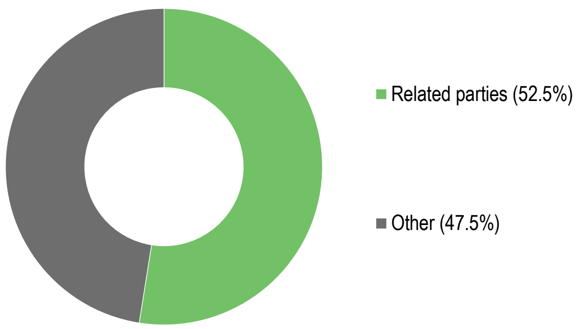


Source: CGI, Edison Investment Research. Note: Leverage costs include preference share dividends, interest and financing charges.

Capital structure

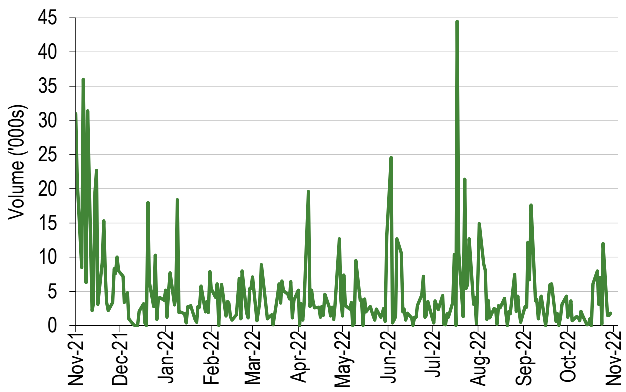
CGI has 20.9m ordinary shares in issue, 52.5% of which are directly or indirectly owned by two of the company's directors, Jonathan Morgan and Vanessa Morgan. Hence, CGI has a free float of 9.9m shares (47.5% of the total) with these holders located in Canada (c 50%), UK (c 30%), Europe ex-UK (c 10%) and other (c 10%). The company has an average daily trading volume of c 5.0k shares on the Toronto Stock Exchange.

Exhibit 12: Major shareholders



Source: CGI. Note: At 31 October 2022.

Exhibit 13: Average daily volume



Source: Refinitiv. Note: 12 months to 14 November 2022.

The board

CGI's board has three non-independent and four independent directors, who collectively have an average tenure of c 18 years. Vanessa Morgan is chair of CGI and president and CEO of MMA; she joined CGI's board in 1997. Jonathan Morgan, president and CEO of CGI and executive vice-president and COO of MMA, joined the board in 2001. Michael Smedley is CGI's longest-serving director, having been appointed in 1989; he is a director of MMA. The four independent directors and their years of appointment are Neil Raymond (2002), James Billett (2005), Michelle Lally (2015) and Marcia Lewis Brown (2020).

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