Canadian Equities: It Pays to Be Picky

Canada reached a new benchmark recently, honouring its 150th birthday with fireworks and fanfare. Canadian equities, on the other hand, have generally given investors less to celebrate over the past six months, turning in a more subdued performance than its market-leader days of 2016. Les Stelmach and Izabel Flis discuss the dynamics at play and what is working in a market that seems stuck in the mud.

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- Izabel Flis

Q: What is your sense of the current environment?

Les Stelmach: The market is a real mixed bag at the moment. Generally speaking, Canadian equities have been underperforming relative to the United States and it is pretty easy to see why. Together, the Energy, Materials and Financials sectors make up two-thirds of the S&P/TSX Composite Index. All three sectors have been facing headwinds, making it difficult for the broad market to outperform. Looking at Energy, for example, weaker commodity prices and a challenging investment outlook for Canadian energy equities have prompted a generally tough go in the first half of 2017. I believe a lot of factors, which lie beyond companies' control, underpin the current malaise. This can range from shifting public policy decisions or indecision, to the realities of overused US production data skewing the picture of global oil production, which in turn influences crude oil supply projections and pricing.

Q: Can you elaborate?

Les Stelmach: In the truest sense of the term, this is a stock picker's market, where you can be in the right sector but pick the wrong company, or be in the wrong sector and pick the right company. In this kind of market, those individual decisions greatly influence performance.

For instance, despite my comments on the Energy sector, you see some oilfield services stocks doing well in a generally tough market. Those firms whose services match the current development trends are fully contracted, prices are increasing and business conditions have improved. Conversely, given the changes in the business environment, traditional drilling companies are facing a very competitive market.

Izabel Flis: We have been seeing diverging performance in Canadian equities over the past several months. Despite a rotation into cyclical sectors, in late 2016 and earlier this year, defensive names have done well. We have also seen a nice rebound in Consumer Staples, which had been negatively affected by deflationary pressures. However, even the better-performing sectors, operating in the shadows of the big three (Energy, Materials, Financials), require an idiosyncratic approach.

Q: Where are you finding opportunities?

Izabel Flis: Enbridge Inc. is a long-standing name in our portfolios. The company has a diverse portfolio of attractive assets that enjoy healthy protection driven by scale, strategic positioning and an integrated service offering. The majority of its revenue streams are governed by either regulatory or contractual frameworks, which present clear avenues of positive cash flow over the long term. Enbridge boasts a solid track record of strong returns on invested capital. In a challenging domestic environment for large-scale pipeline infrastructure development, we see the company's February merger with US-based Spectra Energy Corp. as a positive move. It further diversifies the company by asset, product and geography. In our view, the merger creates an opportunity for Enbridge to generate additional shareholder value. The company is now the fourth largest firm, in terms of market capitalization, on the S&P/TSX Composite Index.



Les Stelmach: We continue to see an interesting thesis in Restaurant Brands International Inc. It owns well-known firms such as Tim Horton's, Wendy's and recently acquired US firm, Popeyes Louisiana Kitchen, Inc. The company is known for buying businesses that have demonstrated some success and market penetration. Restaurant Brands then makes them more efficient, which translates into greater free cash flow. The firm is pretty good about delivering those benefits back to shareholders. Since its initial public offering in 2014, Restaurant Brands' dividend has doubled.

Q: How do issues such as US tax reform and renegotiating NAFTA figure in your decision making?

Les Stelmach: You cannot necessarily draw a straight line from what the President of the United States says and what will come to pass. This creates an air of uncertainty for Canadian businesses. However, while such factors may be added to our decision-making mix, our portfolios are constructed independent of daily themes emerging south of the border. We expect some market volatility in the coming months based on the markets' expectations for US policy progress by this fall and other themes, such as whether OPEC countries are adhering to production quotas. In our view, volatility is not necessarily a bad thing. As active managers, we look to take advantage of those dislocations.

Izabel Flis: I think with uncertainty comes a general sense of angst. Take the noise around renegotiating NAFTA as an example. The current lack of clarity makes it difficult to assess potential risks that may emerge. We do know it will not be a one-size-fits-all situation. We expect, for instance, that some companies will be neutral on NAFTA, experiencing little to no direct impact. Regional and national telecom companies with Canada-only operations are a case in point. Alimentation Couche-Tard Inc. is another example. It is a leading global convenience store operator, with locations predominantly across Canada, the United States and Europe. The company has a strong track record of growth and maintains a healthy financial position. For Couche-Tard, whose operations beyond North America are becoming a bigger part of the picture, we expect the NAFTA story to have little impact. As an aside, while Couche-Tard faces other issues such as evolving car fuel options, the improving US economy and proposed tax reform could benefit their business.

No doubt, for some companies that do business in the United States, there will be fallout from a potentially revised NAFTA. I believe it is insufficient to focus on just one part of the picture as we are also working in a rising interest rate and low Canadian dollar environment. For us, assuming a broadly positive or negative position is too simplistic.

Q: We have been seeing considerable merger and acquisition (M&A) activity. Do you expect more to come?

Izabel Flis: Yes, we do. It has been a tough environment for organic growth of any significant size, particularly in the Energy sector. So, for a variety of reasons, companies have been looking to create shareholder value by strategically buying assets that can help strengthen their competitive position, offer attractive growth opportunities and come at the right price. We have also been seeing this in the Utilities space and expect the M&A theme to continue throughout 2017.

Q: For income-oriented investors, what is your sense of the Canadian equities dividend-paying landscape?

Les Stelmach: As compared to a couple of years ago, I think dividend-focused investors are generally breathing easier. However, once again, I would give the market a mixed review as we have seen solid dividend performance year to date out of some Consumer Discretionary, Telecom and Utilities stocks where Energy and Financials have been weaker.

Q: Looking ahead, what are your thoughts?

Les Stelmach: There is room for optimism in Canada, just not equally weighted across all sectors. As long-term investors, we recognize that with the exception of 2016, Canada under-performed the United States in the preceding five years whereas long-term total returns for both countries, whether 10, 15, 20 years, are very similar. So unless you believe that Canada and Canadian companies are going to be somehow changed and uncompetitive as compared to the United States, then one can expect a positive reversion to the mean over time. Clearly, Canadian equities have the ability to perform better on a broad basis. In the meantime, we remain focused on stock picking with fundamentals and discipline in mind, knowing it pays to be selective.