November 2018

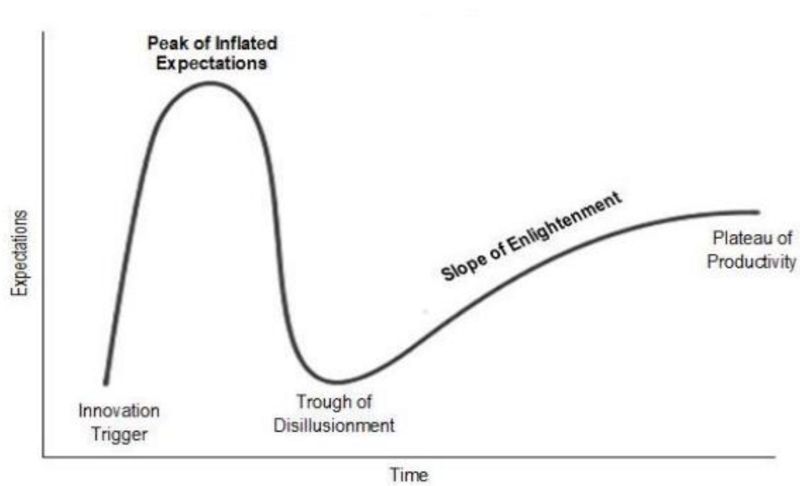
Classic Contrarian Value Opportunity, or a Disruption Trap?

Kim Shannon's script from the Capitalize for Kids Investors Conference.

I have been fortunate to be able to work in the capital markets industry since 1983. Over that time, I have come to believe that markets reflect human nature as much as they do financial fundamentals. The markets are more of a social science that shift and flow with human trends rather than a classic, repeatable-experiments science. From my front row seat these last 35 years, I have seen many market obsessions ebb and flow. I believe this current obsession with technological disruption, has once again perhaps gone a bit too far, a bit too fast.

Gartner's famous "Hype Cycle" documents that after a new technology trigger, humans can get overly enthusiastic about how far the technology can be adapted and take their expectations too high. As limitations become clearer, expectations get dashed to depths of despair and finally a realistic, balanced expectation on how the technology will actually be used is embraced.

Gartner Hype Cycle



Not all new technologies live up to their early expectations. These expectations impact the perceptions of certain industries. Some get disrupted rapidly. Others do not live up to the early concern and the impacted industry adapts and evolves.

Today, the talk of disruption traps is loud and aggressive and may be seeking to rapidly claim more victims than is likely to occur. This new theme may be creating wonderful short- and mid-term value investment opportunities. The environment feels reminiscent of the 2000 Technology Bubble, where "old economy" stocks became extraordinarily cheap as investors chased the inflated high flying TMT (Technology, Media, Telecom) stocks.

I suspect this current zeitgeist has helped a new book "Factfulness" onto the bestseller lists (the author's Ted Talks have garnered 35 million views and Bill Gates is promoting the book).

Written by Hans Rosling, the book demonstrates that the world is actually in much better shape than we believe because we dramatize what we observe. According to the book, we are subject to ten instincts (negativity, fear, urgency, gap, straight line, size, generalization, destiny, single perspective and blame) that lead to misconceptions in how we interpret our world. These instincts were useful when we were more vulnerable hominids, but may be less supportive in our modern media era.

Contrarian value managers have instinctively taken advantage of this phenomenon since the technique was launched. We actively seek out overlooked, underfollowed, beaten-up and under-loved stocks and industries, and look at them with a more balanced perspective to determine if they have the potential to revert higher in the future and earn excess returns.

There have been numerous examples of misjudgements of future trends in the past, which leads us to have some confidence that the current dystopian view that technology will rapidly disrupt and destroy many industries is not necessarily true. And we can use many of the Factfulness instincts to highlight potential positives.

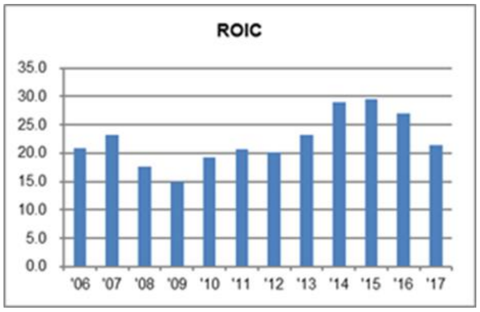
One company we believe presents an opportunity for value investors is a large-cap Canadian name, but rather than tell you up front what this stock is, let's look at the facts first.

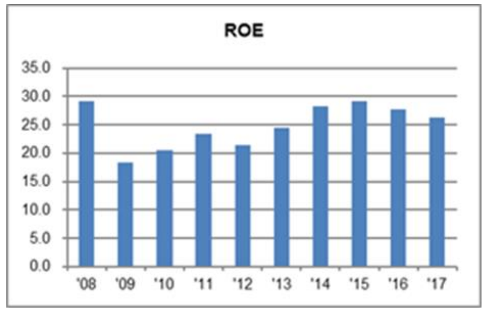
This stock is inexpensive on a price-to-earnings basis and is trading almost 50 percent below its all-time high.

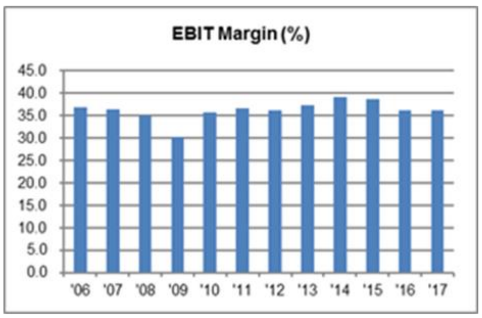
Source: FactSet.

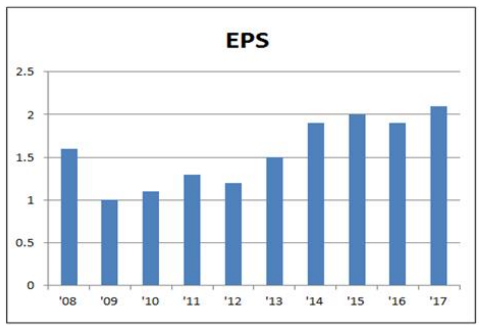
The company has modest financial risk. Net debt to total equity is 0.43, interest coverage is an extremely comfortable 25 times and debt repayability is a very low risk at 2.3 years, ensuring that the dividend is well covered by cash flows and at no risk of being cut given a lack of financial stress.

Further, our pick has solid and generous profits and earnings.





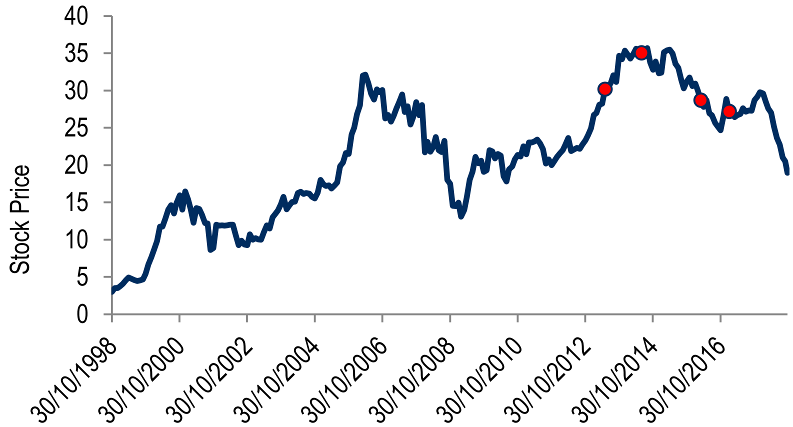




Source: FactSet.

This stock also has a return on invested capital and return on equity of more than 20 percent, EBIT profit margins of more than 30 percent and a rising earnings per share that is expected to rise next year as well. These are extremely attractive features suggesting a stock worthy of a premium multiple.

Year-to-date, insiders have been buying the shares and at an increasing pace as the price has fallen. We all know insiders have many reasons to sell, but just one reason to buy. Clearly they believe the stock is misunderstood by the market. They have also announced that they believe the stock is undervalued and they intend to increase their pace of share repurchases at these levels.



Source: FactSet

It may come as a surprise to many that Sionna would publically choose to celebrate this stock, CI Financial, as a buy, given our history with the company.

However, who would know better than us, the considerable business strengths of our former business partner? Business strengths that include:

1) They were, and still are, a formidable, disciplined and phenomenal sales machine.
2) We can attest to how single mindedly focused on cost control they can be (at times a strength and a weakness).
3) After acquiring Spectrum United in 2002 they dismantled a significant amount of costs. After two years, most of the assets had been retained and, by my reckoning, just a handful of former employees remained (suggesting it is an incredibly scalable business).We expect the recent Sentry acquisition will deliver excellent earnings growth as they fully integrate the business in a similar fashion.
4) They are an aggressive and skillful capital allocator. They were one of the first growing public companies who chose to voluntarily shift to an income trust model (designed to raise capital for modest growing firms) because they believed it met shareholders' interests for after-tax returns and yield, and would better support the growth of the stock by having a higher payout ratio. It was the shift of firms like CI to income trusts that eventually led to the government shutting off the structure.

We like to meet directly with management teams to finish our due diligence prior to investing. Our first calls to CI to meet management before investing were not immediately returned. However, after they saw our initial purchases they began engaging with us. The hatchet was buried in the interests of mutual gain.

So why is the stock, despite the prior compelling features, trading so inexpensively?

First, the stock's weakness was exacerbated by the company's recent decision to cut the dividend virtually in half. Traditionally, cutting a dividend is due to an inability to pay. But that wasn't the case with CI.

CI commented, “We will have increased flexibility to invest our cash flow in the best opportunities to the benefit of our company and shareholders. We strongly believe that the best use of free cash flow is to aggressively buy back CI shares because they offer such compelling value. Each Share bought back is accretive to earnings.” The day before this announcement the stock was $22.98, which would be a 20 percent return from here.

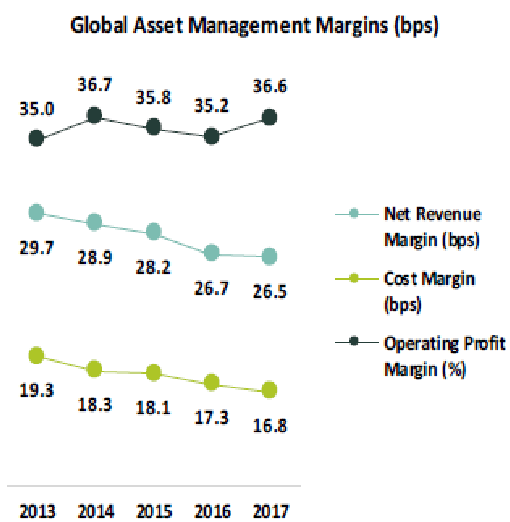
Given our appreciation of their quality of capital allocation skills, we were able to immediately appreciate the dividend cut to use the retained proceeds to buy back shares instead. Management believed that the stock price was so low that the purchase of the stock and anti-dilution would create more future value for investors.

Secondly, and more pervasively for the industry, we believe that the initial weakness was due to an overall negative perception of active management and mutual funds. Multiple pressures and issues have been weighing on these stocks. Regulatory pressures, fee reduction pressures, redemption patterns, popularity of lower fee substitutes (ETFs and smart beta funds) and the lower overall returns of late have all weighed on perceptions of active asset managers.

The extreme headlines that have been promulgated in our industry suggest (as Factfulness does) that the negative perception hanging over active management may be a tad over-wrought.

When we looked at the industry for positive developments and moderating views and signals, we were able to find them as well.

Globally, despite downward fee pressures of 3-4 percent per annum, asset managers have been able to hold profit margins above 30 percent through synergistic acquisitions (due to the significant economies of scale present in the business) and cost control by the adoption of efficient technology.



Source: BCG, Bernstein Analysis

Further, the alternatives space (hedge funds and private equity) have proven over the last decade that they have capacity issues, which led to underperforming the S&P 500 over that time. We suspect that infrastructure, with currently very low cap rates, will join this dismal trajectory. We anticipate the drainage of flows from traditional investing may return.

We believe the concerns over disruption, like the “old economy” concerns of 2000, are likely overdone and that a revaluation to a more realistic view based on fundamentals and facts will lead to excess returns.

In conclusion, we believe that CI Financial, the largest independent fund manager in Canada, will not only survive, but more likely thrive. It is a classic contrarian value buy that we believe can revert to our estimate of its intrinsic value, which we believe could provide an attractive return of 50-60 percent.

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