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WHERE ARE THE BARGAINS?

In the search for bargains or value, the starting point is often in bad news. Clearly, there is no shortage of negatives these days, from trade wars, mercurial policy changes, extreme rhetoric, Hong Kong, Brexit, Iran, India and Pakistan, recession talk and much more.

What is interesting is that stock markets are not far off their historic highs. The old saying still holds: "Bull markets climb a wall of worry".

So where can long-term value be found? The answer is: "beyond the obvious". A recent event in Canada provides some direction.

In mid-August 2019, Jim Pattison, probably one of Canada's pre-eminent business operators and hidden bargain hunters, paid an 82% premium above the public market per share price to buy the Canfor Corporation shares he did not already own. Mr. Pattison is a long-term investor with an eye for value and his $981 million investment should not be viewed in isolation.

This particular investment is, in some measure, reflective of the broader overall fact that publicly traded markets are not ascribing appropriate valuations to many listed companies.

There are numerous underlying reasons for this. Public capital markets are being "hollowed out" by Investment Advisors focusing on packaged products such as Exchange Traded Funds ("ETFs"), which invest primarily in larger companies included in various indicies. Further, most larger Investment Dealers' Investment Advisors are being constrained to recommend only larger, presumably "safer" companies. As a result, a significant number of larger investors end up owning some of the same companies (WSJ – Crowded Trades July, 29, 2019). Further, many computer based trading systems focus on the shares of larger companies where trading activity is triggered by pre-programmed events or even words.

This leaves many smaller to mid-sized enterprises as market orphans with little or no research coverage or brokerage sponsorship. In many cases, companies within this smaller profile group trade at significant discounts from their intrinsic worth.

The bottom line is the demand for small to mid-sized publicly traded companies is currently very anemic.

The adverse impact of this skewed demand for larger companies has also become apparent in the supply of equities. With the notable exception of Cannabis companies, packaged products such as “ETFs” and existing “add on” financings, little in the way of new corporate issues is being offered to investors. The costs and risks of an initial public offering (“IPO”) are causing many companies to stay private or delay an IPO until the company is mature and can shoulder the burdens imposed on public entities. This, of course, removes attractive investment choices during their early, high growth phase and admittedly, higher risk phase. In many cases, IPOs of mature companies often represent an “unload” phase for earlier investors.

Further, share buy backs are shrinking the amount of publicly traded shares available for trading. Historically, companies and entrepreneurs did well to have an IPO. Now it is the opposite. To take Mr. Pattison’s example, given inadequate market valuations, it can often make more sense to take a public company back into the private world.

To summarize: “Where are the bargains?”

In a blanket statement, I would suggest the following:

1) Look within the publicly traded securities environment – Where value is not fully recognized.
2) Low interest rates make takeovers, buy backs and mergers very appealing. This can become more of a factor going forward.
3) Given record low interest rates, investors will focus more on ownership (equities) rather than debt or bonds.
4) Even though larger enterprises are still attractive – Smaller to mid-sized companies can be value compelling.

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Things to look for:

1) A company with a strong balance sheet, that is, high liquidity. Those companies can be acquisitors in hard times.
2) Dividend yields. In Canada, with dividend tax credits, this income source can be very attractive.
3) A unique value proposition in terms of operations or competitive barriers.
4) The historic growth of the enterprise.
5) The real value of the business relative to its public market price.

None of this guarantees short-term success as volatility will no doubt continue to be a factor. The point to consider is the demand and supply trend influence on overall share prices. This will contribute to long-term upward price pressures.

Thomas S. Caldwell, C.M.
Chairman, Caldwell Investment Management Ltd.
Chairman, Caldwell Securities Ltd.
President, Urbana Corporation

September 9, 2019