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BUILDING WEALTH

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ETFS GAIN MORE TRACTION

By Gordon Pape, Editor and Publisher

If you can't beat them, join them.

That's the approach being taken by a growing number of traditional mutual fund companies as they expand into the ETF (exchange-traded funds) business.

Mackenzie Financial, AGF, Dynamic, RBC, and TD have all launched new ETFs in the past couple of years. In April, Manulife and Desjardins entered the field. Fidelity has started an ETF line in the U.S. and it's probably only a matter of time until Fidelity Canada does the same. During March and April, 24 new ETFs were launched in this country.

Mutual funds still dominate in terms of assets under management (AUM) by a wide margin. As of the end of April, the ETF industry reported AUM of $126.3 billion. That was up $3.3 billion from the previous month. The traditional mutual funds business is more than 10 times as big, with assets of $1.39 trillion as of the end of March. You might think the mutual fund companies would just dismiss ETFs as a bothersome fly.

But ETFs are growing at a faster rate and no wealth management company can ignore that for long. At the end of 2006, Canadians had only invested $15.2 billion in ETFs. A decade later, that figure was $113.6 billion. That's an annualized growth rate of more than 22%.

Investors are opting for ETFs for three reasons. First, they are relatively easy to understand. Second, they are cheap – some funds charge management fees of less than one-tenth of a per cent. Third, they are liquid. You can buy or sell at any time either on-line or by calling your broker.

But how do they fare in investment terms? We keep reading stories about how index funds continually outperform actively managed funds. Is that really the case? I did an analysis of three of the most popular ETFs and this is what I found.

Canadian equity funds: The most widely held ETF that tracks the full TSX Composite is the iShares S&P/TSX Capped Composite Index ETF (TSX: XIC) with assets of more than $3 billion. It has been around since 2001, so we have a decent track record with which to work. As of April 30, this ETF was showing a 10-year average annual compound rate of return of 4.34%. That is much better than the 3.18% average for the Canadian Equity category, as reported by GlobeFund, which comprises both mutual funds and ETFs.

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ETFs – continued from page 1…

There are a few actively managed mutual funds available to the general public that have beaten XIC over that period. They include Mawer Canadian Equity (+7.97% over the decade), Beutel Goodman Canadian Equity Fund (6.15%), BonaVista Canadian Equity (5.88%), and Fidelity Disciplined Equity (4.71%). However, most actively managed funds fell well short of matching XIC's returns.

(Note that I did not included F-series funds or those with unusually high minimum investment requirements in this analysis.)

U.S. equity funds: The iShares Core S&P 500 Index C$-Hedged ETF (TSX: XSP) is the leader here in terms of assets at $4.1 billion. However, the falling loonie has compromised its returns, which averaged only 9.81% over the past three years. There is a smaller unhedged version of this fund that trades under the symbol XUS. It shows a three-year average annual gain of 18.37%.

That's almost the same as the BMO S&P 500 Index ETF (TSX: ZSP), which is the largest unhedged U.S. equity ETF. It has a three-year average annual compound rate of return of 18.35%.

To compare these to actively managed funds on an apples-to-apples basis, we need to take currency variations into account. The return on the both the unhedged ETFs is impressive and there are only a few U.S. dollar-denominated mutual funds with the same general mandate that beat them. They include the TD U.S. Blue Chip Equity Fund (+19.33% over three years), the Beutel Goodman American Equity Fund (+18.9%), the CIBC American Equity Fund (+18.72%), and the Mackenzie U.S. Dividend Fund (18.55%).

Global equity funds: The BMO MSCI EAFE Index ETF (TSX: ZEA) is the leader here in assets under management. It tracks the performance of large and mid-cap stocks in countries around the globe except the U.S. and Canada. It recently passed its third anniversary and showed an average annual compound rate of return of 8.39% over the three years to April 30. That is comfortably ahead of the group average for the International Equity category of 7.09% but there were several actively managed mutual funds that bettered it by a wide margin.

One of the most impressive was the Trimark International Companies Fund, which posted a three-year average annual compound rate of return of 14.51%. This was despite having a much higher management expense ratio of 2.98% compared to only 0.22% for ZEA. Sometimes you *do* get what you pay for.

The bottom line: Based on this small sample, ETFs are doing the job for investors. Unless you are very skilled (and lucky) at picking actively managed mutual funds, you will probably do as well or better by investing in a comparable ETF. If you want to know why this segment of the wealth management industry is growing so fast, there's your answer.

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RYAN IRVINE PICKS MERITAGE HOSPITALITY

We are joined this week by contributing editor Ryan Irvine, who has a new stock pick for us. Ryan is the CEO of KeyStone Financial (www.KeyStocks.com) and is one of the country's top experts in small caps. He is based in the Vancouver area. Here is his report.

Ryan Irvine writes:

We're finding a number of attractive small-cap stocks in the U.S. right now and one I would like to bring to your attention is Meritage Hospitality Group Inc. (OTC: MHGU). Here are the details.

Background: Meritage owns and operates a network of branded restaurants in the quick-service and casual dining restaurant industries. The company operates approximately 185 Wendy's restaurants across seven states within the quick-service restaurant (QSR) industry and five casual dining restaurants under the banners Twisted Rooster, Crooked Goose, and Freighters in the state of Michigan. Meritage's strategy is to further consolidate the existing network of Wendy's franchises in North America through acquisitions and to improve sales and profitability of acquired restaurants through integration into its IT platform and restaurant remodelling.

The company has a market cap of $128.3 million (dollar figures in U.S. currency) and about 8.6 million shares outstanding (fully diluted). About 65% of the stock is held by management, so the interests of the company and the shareholders is closely aligned.

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Meritage – continued from page 2…

Financial results: Meritage reported solid financial performance and record first-quarter revenues. Sales increased 14.7% to a first-quarter record of $62 million from $54.1 million for the same period last year. Consolidated EBITDA (a non GAAP measure) increased 81.3% to $5.3 million compared to $2.9 million last year. Net income increased 244.7% to $1.9 million from $541,000 for the same period in 2016. Earnings per share (diluted) for the first quarter of 2017 were $0.22 compared to $0.06 a year ago. Full financials were not provided with the earnings release and are expected in mid-to-late May.

Outlook: The company has already made substantial progress on its current five-year plan, which commenced at the start of the year. Meritage began 2017 with 175 restaurants and a target of expanding to up to 400 restaurants by the end of 2021. Since Jan. 1, the company has acquired eight Wendy's restaurants and has an additional 57 Wendy's in four Mid-Atlantic states under definitive agreement to be acquired during the second quarter of 2017.

The company estimates the combined 69 restaurants acquired in the first half of the year will add approximately $90 million in annual sales and be accretive to earnings going forward. Meritage plans to accelerate its Wendy's reimaging campaign in 2017 with 30 restaurants under development and the 57 additional restaurants that are being acquired. The company expects to update its 2017 financial targets following the completion of the upcoming restaurant acquisitions, which are anticipated to accelerate the five-year growth plan.

Valuation: Meritage reported approximately $1.02 in diluted earnings per share (before one-time expenses) over the previous 12 months, which equates to price-to-earnings valuation of 14.6 times. Looking forward, the company is targeting revenue growth of $90 million from recently announced acquisitions, which equates to a 37% increase over reported revenue in the previous 12 months. We anticipate some fluctuation in profit margins depending on the timing of expenses associated with acquisitions and restaurant reimaging; however, over the course of the five-year plan, we anticipate an overall margin increase resulting from economies of scale. Considering the strong growth potential, we believe that Meritage offers attractive value for investors looking to hold the stock for at least one to three years.

Risks: Meritage trades on the OTCQX, which is top tier of the three marketplaces for trading over-the-counter (OTC) stocks (roughly equivalent to the TSX-Venture). Because Meritage has less than 2,000 shareholders, securities regulations do not require the company to release its financial statements and disclosure documents on the EDGAR database. Meritage's audited annual and unaudited quarterly financial statements (as well as additional disclosure documents) are available on the OTC Markets Group website (www.otcmarkets.com).

Investing in OTC listed stocks is generally considered to be higher risk and investors should weigh their exposure accordingly. In the case of Meritage, the industry and the business plan are relatively easy to understand, which helps mitigate the level of risk.

Conclusion: Meritage reported very solid preliminary financial results for the first quarter of 2017 with 15% growth in sales and a 245% increase in earnings. Strong performance has been the direct result of the company's ongoing restaurant network expansion and reimaging program.

What we like about Meritage is that it is a simple to understand business with an excellent track record of achieving growth targets and an aggressive but fully achievable growth plan. Considering the strong fundamentals underpinning the business, we believe that Meritage offers attractive value.

Action now: Buy. Canadian brokerages (and online discount brokers at all the big five banks) will allow purchases on the OTC in regular trading accounts, particularly for an OTCQX company. You may not be able to buy OTC listed stocks in registered accounts.

In terms of the limited share count, we recommend that readers place limit orders below $15 and be patient. We are looking to hold the stock for three to five years and we expect liquidity to improve over that time.

The closing price on Friday was $14.85.

RYAN IRVINE'S UPDATES

Exco Technologies Limited (TSX: XTC, OTC: EXCOF)

Originally recommended on Feb. 27/12 (#21208) at C$4.25, US$4.22. Closed Friday at C$11.73, US$8.60.

Background: With roots that date back to 1952, Exco Technologies is a global supplier of innovative technologies servicing the die-cast, extrusion, and

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Ryan Irvine's updates – continued from page 3…

automotive industries. Through its 18 strategic locations in 10 countries, it employs over 6,500 people and services a broad customer base.

Stock performance: The stock was recommended in February 2012 as a Buy at $4.25. At the time of our most recent update in February the shares were trading in Toronto at $10.45 and we advised buying in that range. The shares moved up to about $13.75 in March and then pulled back to below $11 before advancing again.

Financial results: Second-quarter 2017 (to March 31) revenues rose 15% to $153.8 million from $133.4 million in the same quarter last year. Year-to-date sales were $306.9 million compared to $264.3 million – an increase of $42.6 million, or 16%.

Consolidated net income for the quarter was $12.6 million ($0.30 per share), compared to $9 million ($0.21 per share) in the same quarter last year – an increase in net income of 40%. Year-to-date, consolidated net income was $24.1 million ($0.57 per share), up 16% from $20.8 million ($0.49 per share) last year. Net income in the current year-to-date period was adversely impacted by $1.2 million ($0.03 per share) of non-operating costs related to the closure of the company's ALC's (Automotive Leather Company) subsidiary operations in South Africa and Lesotho.

Risks: There are two risk factors we need to highlight.

Lower U.S. vehicle sales: U.S. consumers bought a record number of new cars and trucks in 2016. A repeat performance in 2017 could be a tall order.

Low gas prices, rising employment, and low interest rates kept buyers coming to car dealerships last year. There was also the allure of new technology, including backup cameras, automatic emergency braking, and Apple CarPlay in new vehicles such as the Chrysler Pacifica minivan, the Honda Civic, and the all-electric Chevrolet Bolt.

Auto industry publication WardsAuto put the seasonally adjusted annualized rate (SAAR) for light vehicle sales in March at 16.53 million units. Industry consultant Autodata put industry SAAR at 16.62 million units for March. That was below the 17.3 million units analysts polled by Reuters had expected, and the first time since August that the SAAR – a crucial industry metric – fell below 17 million.

Mitigating the risk is that SUV sales remain an area of growth and Exco has more content in this area.

Border taxes: Throughout his campaign, U.S. President Donald Trump took what most would call a protectionist stance. In this regard, there has been talk of a border tax, particularly in relation to companies doing business in Mexico. This potential border tax is thought to be in the range of 20%.

We look at these types of potential threats on a net basis to Exco's business. While the border tax would be a negative, a reduction in the U.S. corporate tax rate to the range of 15% would be a significant benefit as Exco pays approximately 35% in tax to the U.S. government on its Mexican operations at present. If the tax rate were to drop to 15% and a border tax of 20% were introduced, it does not net out to the exact same tax bill but it is closer than the headline risk may appear. In addition, we point out that a significant and growing portion of Exco's businesses is conducted in Europe, which appears to be completely outside this potential tax risk.

Conclusion: While the outlook for the automobile sector has been pessimistic among the Bay and Wall Street crowd over the past six months, as expectations for a rising rate environment pressure auto sales, we see the near-term decline of Exco's business as overblown. Emission reduction requirements, vehicle light-weighting trends, market share gains, and interior-trim focused acquisitions continue to provide solid growth drivers and we saw evidence of this in the company's record second-quarter numbers.

The company's record revenue and EBITDA came via positive contributions from both reporting segments. The company's AFX acquisition completed one year of operations under Exco ownership with solid results. Exco's existing Automotive Solutions businesses continue to perform very well. Polytech, Polydesign, and Neocon experienced combined revenue growth of 18% in the quarter (up 22% excluding foreign exchange movements).

Both new programs and new product introductions drove revenue growth in this segment. The ALC business was down in the quarter and continues to be re-positioned with the wind-down of BMW 5 Series seat cover program completed in mid-February and the Audi seat cover and large steering wheel wrapping programs continuing to ramp up.

Exco has done a tremendous job of quickly improving its balance sheet (one that was already healthy) over the past year. Exco's net debt totalled $27.3 million at March 31, down from $44.6 million at Sept. 30, 2016, and approximately $71 million when AFX was acquired on April 4, 2016. We expect the company could be in a net cash position early in 2018, a year and a half after its most significant dollar value acquisition in its history. This sets up the company to continue to add growth on an accretive basis via acquisition, with no dilution, over the next 6-18 months.

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Ryan Irvine's updates – continued from page 4…

Over the last 12 months, after factoring in the company's recent acquisition, revenue was $632 million and EBITDA was $92 million. We expect the company at the very least to improve these figures as margins improve in the second half of 2017, leaving the stock trading with an attractive Enterprise Value/EBITDA ratio of 5.53. Consolidated EBITDA for the second quarter totalled $23.4 million compared to $16.9 million in the same quarter last year, an increase of 39%. Year-to-date, consolidated EBITDA totalled $46.8 million compared to $37.9 million, an increase of 23%.

While sales growth will slow in the second half of 2017 as the company has now had one year of AFX in the fold, we expect continued year-over-year growth in EBITDA. The company trades at reasonable valuations long term and has a solid management team with good insider ownership. Over the past six years, the dividend has increased 310% and revenues have increased by a compound annual growth rate of 24%. In terms of fair value one year forward we apply a seven-times EV/2017 EBITDA multiple or 12.5 times 2017 EPS (below market average) to get a price of $15.50.

Dividend: Management announced a 14% increase in the company's dividend to $0.08 per quarter ($0.32 per year), for a yield of 2.7%.

Action now: We continue to view Exco as a long-term Buy in its current range.

GlobalSCAPE Inc. (NYSE: GSB)

Originally recommended on June 27/16 (#21625) at $3.80. Closed Friday at $4.15. (All figures in U.S. dollars.)

Background: Founded in 1996, GlobalSCAPE is a pioneer and worldwide leader in the secure and reliable exchange of business information. The company provides enterprise software in a wide array of categories including file management, web development and multimedia utilities. The company's managed file transfer (MFT) platform helps organizations securely transfer data with enhanced automation, regulatory compliance, governance, and visibility controls data between diverse and geographically separated network infrastructures. GlobalSCAPE has tens of thousands of customers worldwide, including global enterprises, governments, and small and medium enterprises.

Stock performance: The stock was recommended in late June 2016 at $3.80. It was reviewed in February as a Buy at $3.88. It has been trending higher since.

Financial results: Revenue for the first quarter increased 13% to $8.3 million from $7.4 million in the same period of 2016. The increase was driven by a 16% increase in revenue from EFT (electronic file transfer) platform products that accounted for more than 90% of total revenue.

Net income totaled $751,000 ($0.03 per share, fully diluted), an improvement from $392,000 ($0.02 per share) in the first quarter of 2016. Adjusted EBITDA increased 69% to $1.4 million from $826,000 in the first quarter of 2016.

Conclusion: GlobalSCAPE's first quarter marked a return to solid earnings growth. Notably, the company achieved its 18th consecutive quarter of profitability.

In terms of near-term fair value, GlobalSCAPE's consensus earnings estimate for 2017 is $0.23 per share. By applying a conservative 15 multiple to the earnings and adding in $24.4 million ($1.15 per share) in cash we arrive at $4.60. The company will add cash over the year and holds the potential for further growth with the launch of three new products over the next several months.

Action now: We reiterate our Buy rating for long-term investors with a two to three-year time horizon.

Merus Labs International Inc. (TSX: MSL, NDQ: MSLI)

Originally recommended on March 28/15 at C$2.72, US$2.13. Closed Friday at C$1.62, US$1.18.

Background: Merus Labs International is a specialty pharmaceutical company that acquires and licenses pharmaceutical products and then sells them into select international markets. The company co-ordinates these functions from its Toronto headquarters and its operations in Luxembourg. Merus Labs currently has products in the area of urology/women's health, oncology, anticoagulants, and anti-infective.

Stock performance: I recommended buying a half position of Merus in March 2015 at $2.72. The company' shares subsequently rose to the $3.30 range but were then hit along with the whole Pharma/Biotech sector. At the time of the last review in October the shares were trading in Toronto at $1.27 and I reiterated my Buy recommendation. The stock fell to the $1 range before surging on Thursday as the result of a take-over bid.

Recent developments: On May 11, it was reported that Merus had entered into a definitive agreement under which Norgine will acquire all the issued and outstanding common shares of Merus for $1.65 in cash and assume all debt obligations. The total enterprise value is approximately $342 million.

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Ryan Irvine's updates – continued from page 5…

The transaction price of $1.65 per share represents a premium of 63.4% to the closing price of $1.01 on the TSX on May 10 and a premium of 55.1% over the 30-day volume weighted average price of $1.06 on the TSX.

Merus management stated that after a comprehensive review of strategic alternatives and consultation with Merus's financial and legal advisors and the Special Committee of Independent Directors, the board unanimously concluded that this transaction is in the best interests of the company and its stakeholders.

Conclusion: The deal is likely an opportune one for Norgine as it takes advantage of a depressed specialty pharma market in Canada following the spectacular collapse of names such as Valeant Pharmaceuticals International (TSX: VRX).

Action now: With the segment continuing to be out of favour, Merus was unlikely to hit the $1.65 acquisition price over the next year. As such, we advise readers to tender shares at the offer price and look to employ capital in an up and coming growth stock such as Meritage Hospitality.

GORDON PAPE'S UPDATES

TFI International Inc. (TSX: TFII, OTC: TFIFF)

Originally recommended by Tom Slee on June 11/12 (#21220) at C$17.49, US$17.06. Closed Friday at C$27.97, US$20.80.

Background: This stock was originally recommended as TransForce Inc. The name was changed in December and the TSX trading symbol was also changed to TFII. The company is a North American leader in the transportation and logistics industry. It operates across Canada and the United States, offering package and courier service, truckload and less than truckload haulage, logistics, and other services.

Stock performance: The stock made a strong upward move in the late fall and early winter, hitting a high of $35.83 on Jan. 27. However, it has been trending lower since then and is now off 22% from the January high.

Recent developments: The company released first-quarter results that were in line with expectations, however investors were disappointed by management's guarded outlook going forward.

TFI reported an increase of 22% in total revenue from continuing operations before fuel surcharges to $1.6 billion compared to $867 million in the same period last year. However, that increase in revenue did not translate into the profit gains we might have expected. Adjusted net income from continuing operations was $32.7 million ($0.35 per share, fully diluted) compared to $31.3 million ($0.32 per share) a year ago.

In his comments, CEO Alain Bédard referred to "difficult conditions in the U.S. Truckload market" as a factor in the weak profit growth. Volumes are slipping and rates are being cut in a competitive marketplace. A serious driver shortage is also causing disruptions in the sector.

The CEO also blamed integration costs relating to the CFI acquisition, announced last fall. He said these factors "overshadowed significant profitability increases in all other business segments".

Free cash flow from continuing operations was $29.5 million ($0.32 per share), up 20% from $24.7 million ($0.25 per share) last year. The company said the variation was essentially related to a $10 million increase in net cash from operating activities from continuing operations. During the quarter, TFI International also continued to dispose of excess assets, realizing total proceeds of $15.8 million.

Looking ahead, Mr. Bédard sounded a wary note. "We remain cautiously optimistic in regards to the North American economy given low unemployment and healthy consumer spending," he said. "We are also seeing a modest rebound in the level of investment in the energy sector. These factors should, over time, improve market conditions, but we do not expect any significant improvement before the end of 2017."

Dividend: The shares pay a quarterly dividend of $0.19 ($0.76 a year). The price drop has pushed the yield to 2.7%.

Summary: TFI is doing well considering the difficult economic conditions in the trucking sector. However, we are unlikely to see any significant improvement in the share price over the next year or so.

Action now: Readers who purchased shares at the time of the original recommendation may wish to cash in for a profit of about 60% and move the money into stocks with greater short-term potential. Otherwise, hold. We will continue to follow the stock.

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GLENN ROGERS'S UPDATES

Nvidia Corp. (NDQ: NVDA)

Originally recommended on May 8/17 (#21718) at $103.86. Closed Friday at $127.89. (All figures in U.S. dollars.)

Background: Nvidia is well known for its powerful microchips used in PC gaming. It is also is a leader in Artificial Intelligence (AI) and cloud-based visual computing areas and produces central processing units (CPUs) that provide the brains for mobile entertainment devices, as well as autonomous robots, self-driving cars, and drones.

Stock performance: I recommended the shares in last week's issue at $103.86. Then the company came out with terrific first-quarter results and the price shot up. We're ahead by 23% on this after just one week!

Recent developments: The company's financial statements blew analysts away and set off a scramble to buy the stock. Revenue came in at over $1.9 billion, up 48% from the same period a year ago. Earnings per share using GAAP standards were $507 million ($0.79 per share), an improvement of 126% from the $0.35 reported in the first quarter of 2016.

"The AI revolution is moving fast and continuing to accelerate," said the company's founder and CEO Jensen Huang.

The company says it plans to return $1.25 billion to shareholders this year through dividends and share buybacks. The quarterly dividend is $0.14 per share ($0.56 per year) for a yield of 0.4%.

Action now: Buy on any pullback. The stock shot up last week and we may see some profit taking that would provide an entry point. If the shares dip below $125, take a position.

MEMBERS' CORNER

Senior discounts

Member comment: RBC offers very decent discounts for seniors holding several products. We don't pay anything for unlimited account transactions because we have several accounts including a line of credit dating back to 1991, a minimal monthly TFSA deposit, a Visa credit card, as well as corresponding U.S. accounts (and a U.S. Visa) with RBC Bank (Georgia), which enables me to more easily transfer back and forth. That's particularly handy for Snowbirds. – Tom A.

Member comment: I am unaware of any special rates for seniors. I have a 60+ savings account with CIBC but the interest rate is pathetic (for new deposits there was special interest rate of 2.25% until end of March so I made regular transfers from other cash accounts to take advantage of it). I have a Tangerine savings account paying me 1.6% currently though every three months I have to call to renegotiate interest rate, which is annoying. Best bet is my Outlook Financial savings account, which pays 1.7%. – A.M., Winnipeg

Member comment: By now your mailbox must be overflowing about free checking for seniors at credit unions. I have a free Your Checking 15 account at East Coast Credit Union, the largest credit union in Nova Scotia, and access to an ATM network nationwide, easily findable through their app. I have a MasterCard platinum card that gives me 2% cash back among other options ($150 yearly fee) and free travel insurance until I'm 72. The member direct online bill payment lets me pay bills or email or text cash to grandkids or kids for free even when I'm in Florida. Their high interest savings account is only 55 basis points but there are other credit unions with online options to 1.85%

I can manage my portfolio in a self-directed account through Credential Financial (a national sister company) plus I get free financial planning that is truly free offering any product from any company, also through Credential. So good deal for seniors is spelled...you guessed it: credit union. – Guy S.

Member comment: When my husband turned 55, his checking/savings account with Vancity Credit Union (Vancouver) stopped charging the monthly fee automatically. So I thought that might happen at TD Bank when I turned 55 but no… I phoned and I have to wait until 60 to get my fees dropped. – Christine B.

Member comment: My elderly mother had one of those old "free for seniors" accounts (all the big banks offered them). I was added as a joint account holder so that I could manage her finances. When she died, I was left as the only account holder. Because I was over 60, I was able to add my wife to the same account, which we still hold today. Free everything. Something to consider for anyone with an elderly parent who still owns one of those free Senior Accounts. – Steve B.

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