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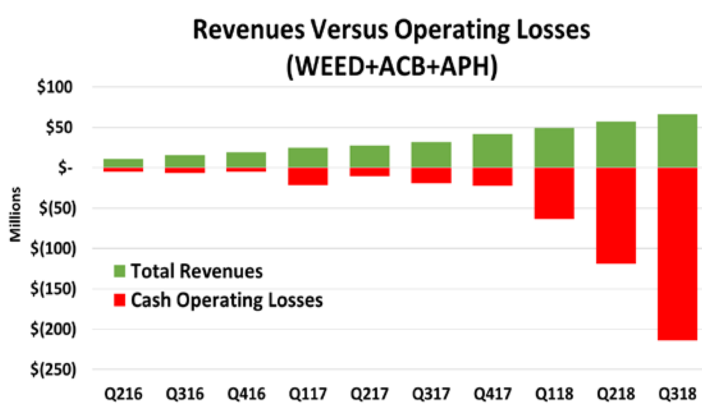
A Little Piece of History

"A rising tide lifts all boats" is generally attributed to President John F. Kennedy. In 1963, he used this phrase in a speech to inaugurate a government-sponsored hydroelectricity project. He believed that if the economy was strong, *all* citizens, rich and poor, would be better off. Unfortunately, history has shown that it doesn't always work like this. For example, the US economy has been in recovery mode for over nine years and in 2018, we are just starting to see evidence of wage inflation. The concentration of wealth over the last 20 years has increased, with the top 10% of US households controlling over 50% of the wealth in 2015, compared to 35% in the 1980s[1]. The debate today largely centres on what to do, if anything, about this trend.

In investing, "a rising tide lifts all boats" has been co-opted to refer to the idea that one should invest in companies that are operating in rapidly growing industries. When we take people out of the equation, do businesses at least follow this rule? We would argue it happens less than you think. In the post WWII era, the commercial air travel industry grew enormously, yet it is dotted with numerous airline bankruptcies over the decades. Similarly, US smartphone penetration grew from 6% in 2007 to over 81% in 2016[2], yet first movers like Nokia and Research in Motion (now Blackberry) lost virtually all their market share (and most of their equity value).

The unique past of one of QV Canadian Equity Strategy holdings, CN Rail (CNR), highlights the difference between a growing industry and a good investment. From the 1800s into the early 1900s, CNR's predecessor companies received over $200M (~$4B in today's dollars) of government assistance, numerous tax and regulatory incentives, and large inflows of private investor capital (mainly British in origin). This time period also coincided with a population explosion in the prairies and economic growth on Canada's west coast. Despite these tailwinds, CNR's predecessor companies all effectively went bankrupt and were nationalized by the government in 1919, ten years before the Great Depression[3]. However, since its IPO in 1995, CNR has turned into one of the most profitable and efficient railroad companies in North America. This was not because the railroad industry had a renaissance in the 1990s (in fact, rails were still losing market share to the trucking industry), but because the leadership team at CNR had prioritized efficiency and profitability over business development. A rapidly growing industry does not equate to a good investment just as a shrinking industry does not equate to a bad investment – CNR being a good example of both.

In December 2017, Canada was on the cusp of legalizing recreational cannabis and the excitement was palpable. On this day last year, Canopy Growth Corp (WEED) had already doubled in share price. In the remaining three weeks of 2017, WEED proceeded to rise a further 65%, ending the year with a return of 300%+. The industry itself continued to grow in 2018; however, share price returns have been disappointing. HMMJ, the ETF that tracks the equity values of various players in the cannabis industry, has fallen by 20% year-to-date. Perhaps the reason is that although revenues continue to hit record highs, profitability has gone the other way. The sum of WEED, Aphria (APH) and Aurora Cannabis' (ACB) combined revenues in Q318 totaled $66MM, an increase of an impressive 107% year-over-year. However, for every $1 of revenue the three companies made, they lost $3 in cash operating profit, a marked acceleration from a year earlier (see chart below). Rapid growth will always earn a premium in the market, but growth without commensurate profitability does not equate to a good investment (or a sustainable company) in our opinion. While we expect the cannabis industry to continue to grow, we have yet to find a good potential investment.



Source: CapitalIQ and QV Investors

1. http://harvardpolitics.com/columns/after-the-fall-income-inequality-and-the-great-recession/
2. https://www.comscore.com/Insights/Blog/US-Smartphone-Penetration-Surpassed-80-Percent-in-2016
3. https://www.thecanadianencyclopedia.ca/en/article/railway-history