Middlefield Canadian Income

A long track record of steady dividends and unique exposure to Canadian equity income stocks makes MCT an ideal income portfolio diversifier...

Update
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Overview

MCT offers a straightforward proposition to investors: exposure to Canada, a G7 economy adjacent to the US but with a very different sector make-up to the US. The Canadian equity market has a strong culture of equity income, and MCT has a consistent dividend record. MCT's historical dividend yield is 4.2%.

MCT's portfolio is concentrated in energy, real estate and financials, all three being important sectors for Canadian equities. One of the biggest geopolitical issues of the last year has been energy security, and Canada is a net energy exporter that is consequently running a trade surplus. Higher energy prices have played a role in this, but Canada's status as a stable democratic economy means it is arguably also selling stability and security to its neighbours and allies.

Canada has immigration trends that MCT's manager, Dean Orrico, argues should secure the real estate sector as a long-term anchor of the Canadian equity market. A points-based immigration system prioritises 'economically active' individuals and there is a resulting shortage of housing and other real estate. This is a core area of expertise for Dean and also for Middlefield International, which runs several specialist REIT mandates alongside MCT. Canadian banks typically have high capital ratios, and the major Canadian banks held their dividends during the financial crisis and more recently during the pandemic. They are now benefitting from more profitable lending from higher interest rates.

MCT has a track record of stable dividends and has seen a strong recovery in underlying earnings since the end of the pandemic as portfolio dividends have been restored or even increased. It uses a flexible gearing facility, allowing it to navigate through different periods of volatility.

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Analyst's View

MCT could provide strong diversification to an income portfolio, giving UK investors a relatively unique opportunity to gain exposure to Canada, a developed market with differentiated economic factors, such as net exports of energy and an immigration system which has a positive impact on demographics. One of the most pressing geopolitical issues of 2022, energy security, looks set to be an enduring one, and Canada provides a stable source of energy, now supplying over 50% of US oil and gas imports.

Dean notes that this year's sell-off in REITs has created buying opportunities in some of the larger REITs already in the portfolio. Where he believes that long-term trends are still intact and balance sheets are conservative, he has been buying REIT shares at 40%-plus discounts. He also sees valuations in financials, which are at levels similar to those last seen in the financial crisis. With underlying valuations so low and MCT trading on a double-digit discount, Dean has recently increased his stake in the trust, buying 70,000 shares in October. He goes on to note that even if you adjust for technology stocks, the Canadian market trades at a P/E discount to its US neighbour of two or three turns . While there may be no short-term catalyst to close this discount, for an equity income investor, lower price ratings give greater choice when constructing a portfolio.

MCT has a historical yield of 4.2% and has consistently paid annual dividends of 5.1p per share in equal quarterly instalments since 2017. We think its diversification, steady dividends (even through the pandemic) and 13% discount could appeal to an income-seeker looking to diversify their portfolio.

BULL
Exposure to North American equities through a different set of companies and sectors
Canadian equities typically trade at lower ratings than US equities, and a higher earnings yield is positive for income investors
Canada is a net exporter of oil and gas, making it something of an inflation hedge

BEAR
Gearing can exacerbate losses in market falls.
Canadian market is concentrated on a number of key sectors
Currency differences are an additional risk for income investors

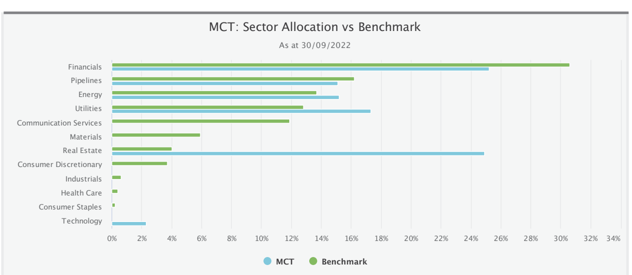
Portfolio

The Canadian equity market is different to the US equity market in a few key areas. First, its sector exposure is more concentrated on real estate, financials and natural resources such as energy, whereas the US has a much larger exposure to technology. Second, Canada has a long history of higher-dividend-paying companies. You might say that equity income is part of the investing culture in Canada, and the market yields c. 3.4% compared to the S&P 500's yield of c. 1.9%. Even if one were to adjust for the US's exposure to technology, manager Dean Orrico believes that the Canadian market currently trades at a discount of about two or three turns of P/E ratio to the US . Clearly lower P/Es are helpful to an equity income investor, as the result is higher earnings and dividend yields on the market.

This structural bias towards equity income is what MCT seeks to capture through a conservative approach to its portfolio, with position sizes for individual stocks being between 1% and 5%. The lower limit on position size helps maintain a disciplined portfolio with no tail of small positions. Gearing is used conservatively and is currently c. 18% , having been as low as 15.8% in June 2022 (see the **Gearing section** for more information). Portfolio turnover is very low, and Dean notes that he has known many of the companies he owns for longer than MCT has existed (MCT was launched in 2006). As such, when markets retreat it's very likely that Dean and his colleagues will add to existing positions rather than initiating new ones, and this is exactly what they have been doing this year, adding to holdings in banks and selected REITs trading at wide discounts of, in some cases, over 40%.

Although the chart below is a recent snapshot, it is a good representation of what MCT's long-term investors should expect, with core components of MCT's equity income strategy being real estate, financials and energy. These sectors are also core sectors for Middlefield generally, with specialist mandates in REITs, for example, being run alongside MCT. We would expect the real estate overweight to endure as this is a key strength for management, who identify it as one of the best long-term sectors for an equity income investor.

Fig.1: Sector Allocation



Source: MCT

Real estate

Canada's REIT sector is well developed and offers many sector-specialist REITs that allow the manager to invest in themes on a granular basis. Key themes that are well represented include housing, accessed through housing and apartment REITs, industrials and offices.

MCT's manager identifies Canada's long-term shortage of housing, which is shaped by Canada's demographics, as a key theme. Another important factor the manager notes is that similarly to the UK, but unlike the US, Canadian mortgage lenders have full recourse to borrowers. In the US a mortgage-holder can simply hand the keys back and walk away, but this situation doesn't really arise in Canada. This means lending is more rigorous and owning a home is a greater responsibility, which also has benefits for Canada's banking sector. We would expect this theme to play an enduring role in MCT's portfolio.

MCT also maintains long-term exposure to sectors such as industrial and retail REITs. The manager has steered exposure to retail away from shopping malls and towards REITs with tenants such as Walmart, which offers essential consumer goods. One driver of returns for the type of real estate that Dean identifies is the conversion into housing of some vast spaces being used as parking lots around some large retail outlets, again playing into the long-term housing shortage theme and with the additional benefit of cementing the customer base of these retail sites.

Dean has seen some value in REITs recently, which he likens to the value he saw during the financial crisis. He has added to the position in CAPREIT (Canadian Apartment Properties REIT), a CAD 7 billion market-cap REIT which after a more than 20% share price fall this year is trading at a small discount to net asset value. Given the long-term housing shortage in Canada, Dean sees this pricing as an opportunity to add to this large market-cap stock while not having to worry about market liquidity. He has also been adding to his holding in Granite REIT, a CAD 4 billion market-cap REIT in the industrial and logistics space. After a 30% share price fall this year, Granite is yielding c. 4.4% and has very conservative fundamentals such as low leverage of 28%. Dean sees this price fall as being disconnected from the reality of Granite's business.

Energy

In contrast to the global oil majors, which are evolving their businesses to include renewable energy by reinvesting profits, MCT's manager notes that the Canadian majors are essentially being run for cash, with investment mainly concerned with maintaining existing production and investment into carbon capture and storage technology, and only limited amounts spent on new production. This is balanced against investors' desire to see dividends maintained or increased. In the manager's view, the global landscape for oil and gas has changed significantly this year, with the Russian invasion of Ukraine putting a spotlight on the provenance of hydrocarbon energy sources. Coming from a developed, democratic nation, Canadian oil and gas is therefore much less controversial in this context. It is fair to say that Canadian production costs are higher, so this theme will have to be monitored carefully if the oil price falls significantly. However, the market does appear to have adjusted quite rapidly to sourcing energy from more stable parts of the world, and this could have an enduring positive impact on the Canadian energy sector, both from a producer and a pipeline perspective.

Pessimists saw the recent cancellation of the Keystone XL pipeline between Canada and the US as a major setback for the Canadian oil industry, but in fact the rise in energy prices and rise in demand for Canadian-sourced oil have seen other existing pipelines up their capacity, allowing companies to capitalise on the opportunity. Part of MCT's exposure to energy comes through pipeline and infrastructure companies. An example is Enbridge, which manages critical energy supply infrastructure as well as US utility assets, that are supply-constrained and in high demand as industrial activity has increased post-pandemic. This dynamic should therefore assist in protecting revenues against inflation. Dean also notes that Enbridge in particular is investing heavily in carbon capture and storage technologies, as well as energy storage assets such as batteries, and is committed to net zero by 2050, meaning the portfolio has some exposure to a greener revenue mix.

More widely, in Dean's view Canadian energy companies are being run to prioritise existing production over new production, with excess cash being returned to shareholders, making them very reliable components of an equity income portfolio.

Financials

Dean notes that Canadian banks have very strong capital ratios that stand up very well in international comparisons. Of key concern to a long-term equity income investor, the major Canadian banks did not cut dividends in the financial crisis or the pandemic, which demonstrates both the strength of their balance sheets and the importance of equity income in the Canadian market. Again, we would expect financials to be an enduring theme in the MCT portfolio. Dean also notes that rising interest rates have improved lending profitability and that he is seeing dividends being increased. Canadian banks are also using their strong balance sheets and positive cash flows to make selective investments into the US, shown for example with BMO's acquisition of Bank of the West, which is expected to be completed at the end of 2022 for $16 billion. Acquisitions such as this are expected to increase the scale and reach of the Canadian banking sector.

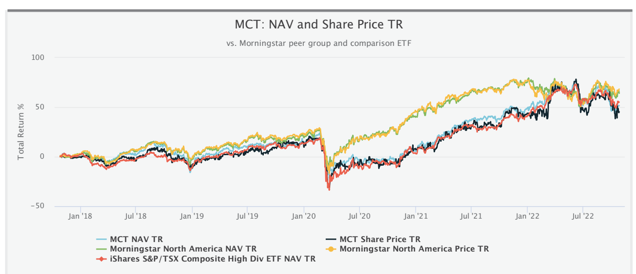
Gearing

MCT has generally employed leverage at a higher level than for example the UK Equity Income Sector which typically sees trusts with single digit percentages of gearing. MCT currently uses short-term flexible debt and has a facility with RBC for the lower of CAD 65 million or 25% of net assets. The manager's view is that flexibility is desirable when it comes to gearing, and indeed gearing has been reduced from c. 19% in May to 15.8% at the end of June 2022 to reduce risk during volatile markets. The most recent gearing figure was 18% at the end of September.

Performance

MCT is benchmarked against the S&P/TSX Composite High Dividend Index, and the performance shown in the graph below includes that of an ETF which is constructed using this index, thus giving a more real-world sense of what an investor could expect as a passive investor in this benchmark. Since its inception in July 2006, MCT has produced an annualised NAV and share price TR of 7.5% and 7.3% respectively, outperforming its benchmark, which has returned 7%. The wider measure of Canadian equities, the S&P/TSX Composite Index, has returned 6.3% over the same period, indicating that over the long term Canadian markets have favoured higher-yielding equities. Over the past five years the trust has returned 7.6% annualised in NAV total return terms versus 8.9% annualised for the benchmark.

Fig.2: NAV And Share Price Tr Over Five Years



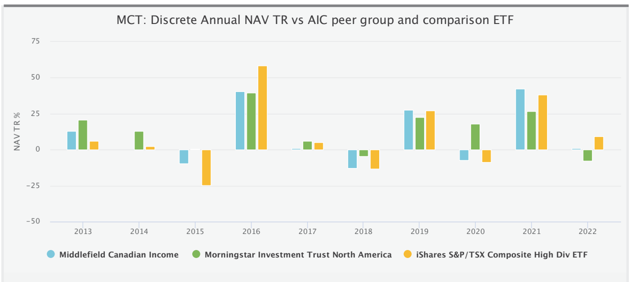
Source: Morningstar

Past performance is not a reliable indicator of future results.

More recently, in the year to the end of September 2022, MCT's NAV has lagged the benchmark, with a total return of -1.5% compared to a rise of just over 7% for the benchmark. One of MCT's biggest sector exposures is to real estate , which historically has been interest rate-sensitive and has seen some large share price falls as a result. However, as noted in the **Portfolio section**, the manager believes that MCT's largest individual REIT holdings are all still performing well and are exposed to positive long-term trends.

By breaking performance down into discrete periods we can see that unsurprisingly, MCT underperformed in 2020 when there was a strong bull market for technology sectors (which the Canadian equity market has a relatively low exposure to, meaning MCT's mandate is structurally underweight to them). Performance against the AIC North America peer group has been more positive in 2021 and 2022 as the technology bull market has reversed, which clearly shows how MCT provides portfolio diversification.

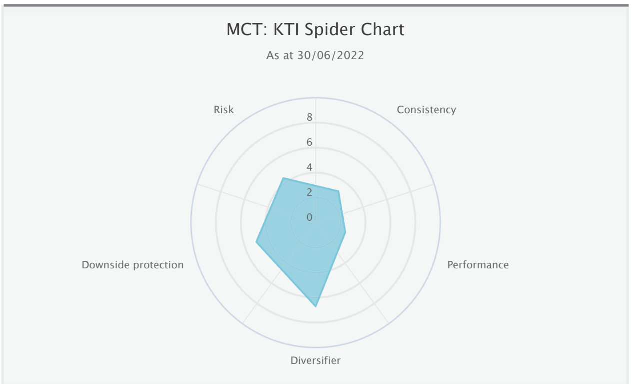
Fig.3: Discrete Annual Performance



Source: Morningstar
Past performance is not a reliable indicator of future results.

Our proprietary KTI Spider Chart is shown below. This shows how MCT has performed versus an expanded peer group of all North American strategies (i.e. the components of the AIC North America and AIC North American Smaller Companies sectors) over the past five years in some key categories. Each category is scored out of ten and based on the returns over the period. Scores are normalised to the peer group, with a higher score indicating a superior characteristic. MCT's strong portfolio diversification is shown very clearly in this chart. Analysis like this is best done over long-term periods such as five years, but it's worth noting that the period over which relative performance was measured covered a time when technology performed particularly strongly, and the North American peer group was typically more exposed to this sector than MCT was.

Fig.4: KTI Spider Chart



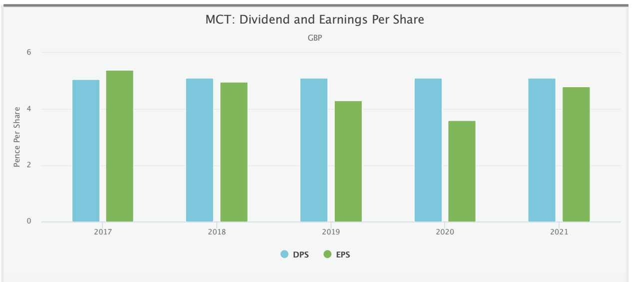
Source: Morningstar / Kepler calculations
Past performance is not a reliable indicator of future results.

Dividend

Together with capital growth, MCT targets a high level of dividend. MCT has maintained an annual dividend of 5.1p per share since 2017, when it made a slight increase from its previous 5p dividend rate. Dividends are paid quarterly in equal amounts in January, April, July and October.

MCT charges two-thirds of its overall costs to revenue, which puts it at the conservative end of equity income trusts and gives it scope to adjust this in future if the board and manager feel the source of returns justifies it. The chart below shows the dividend and earnings per share for the previous five years. One can see the effect of the pandemic feeding through to earnings in FY 2020 (which ended on 31/12/2020) , and how earnings have recovered strongly since. Although we don't yet have an earnings-per-share figure for MCT for this financial year (ending 31/12/2022), dividends totalling 5.1p per share have already been declared, indicating that the board and manager are confident about earnings and capital reserves.

Fig.5: Dividend And Earnings Per Share



Source: MCT

Management

MCT's investment adviser is Middlefield International, the UK-regulated entity of Middlefield Group. Middlefield Group was founded in 1979 and manages mutual funds, closed-ended funds, exchange-traded funds, real estate and venture capital funds. Middlefield's core expertise lies in real estate, healthcare, equity income securities, natural resources and sustainable investment. Middlefield has approximately 50 employees based in Toronto, Calgary, San Francisco and London.

MCT is co-managed by Dean Orrico and Rob Lauzon, who work within Middlefield's team of nine investment professionals.

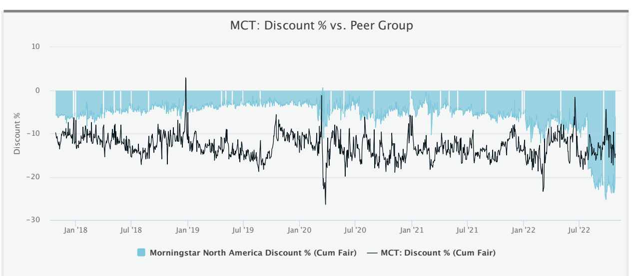
Dean Orrico is president and CEO of Middlefield Group. Dean has over 35 years of investment experience and joined Middlefield in 1996. Dean co-manages several of Middlefield's other strategies, serving as lead manager of Middlefield's real estate strategies while also being involved in the management of the company's healthcare and income strategies. Dean also manages Middlefield's dedicated REIT fund, thus adding to his knowledge and expertise in this important sector for MCT.

Rob Lauzon is managing director and CIO of Middlefield Group. Rob has 20 years' industry experience, having joined the company in 2002. He runs a range of income funds for Middlefield in addition to MCT.

Discount

At the time of writing MCT's discount is 13%, in line with the average discount of 13% over the past five years . MCT's historical discount has remained relatively consistent over the long term, as the graph below shows. We think one catalyst to cause the discount to narrow to asset value would be the slow and steady widening of the share register as MCT's income diversification benefits become more widely appreciated.

Fig.6: Discount % Versus Morningstar North America Peer Group



Source: Morningstar

MCT does not have a formal discount control mechanism but does take annual permission from shareholders to repurchase up to 14.99% of shares, with the proviso that no purchase will be made above net asset value. The board has not used share buyback powers recently.

Charges

MCT's management fee is 0.7% of net assets, which is charged quarterly in arrears. Ongoing charges at the last financial year end were 1.24% compared to 1.14% for the previous financial year. This compares to an average OCF of 0.84% on the North American sector (excluding Pershing Square Holdings), according to JPMorgan Cazenove data. Management fees are specifically charged 60% to revenue and 40% to capital, although as we note in the **Dividend section**, overall costs are split two-thirds to revenue and one-third to capital.

The Reduction in Yield (RIY) figure on the most recent KID is 2% compared to an average of 1.24% for the sector excluding Pershing Square (Source: JPMorgan Cazenove), although we note that methodologies may vary.

ESG

Given energy is a major pillar of the portfolio, MCT will therefore not appeal to the most ardent anti-fossil-fuel investor. However, MCT has an 'average' ESG rating from Morningstar within the open- and closed-ended North American sectors. Given that MCT's equity income mandate leads it for example to favour exposure to energy stocks and to move away from technology stocks, we think this rating is quite positive as typically energy stocks screen lower in ESG ratings than technology stocks do. MCT does screen out tobacco and arms companies from its portfolio, and its full ESG policy can be found here.

Middlefield is an associate member of Canada's Responsible Investment Association (the RIA). The RIA is a national, membership-based organisation that is committed to advancing responsible investment, meaning the incorporation of ESG factors into the selection and management of investments.

ESG considerations are integrated into Middlefield's investment decision-making and monitoring process. As part of its commitment to ESG matters, in 2021 Steve Erlichman was appointed as Middlefield's chair of ESG. Steve is considered one of the foremost experts on governance and ESG in Canada. From 2011 to 2018, Steve was the executive director of the Canadian Coalition for Good Governance (CCGG), where he created and debated public policy positions in relation to ESG issues and led engagement meetings between CCGG and the boards of public companies across Canada. Steve also sits on the board of Canada's RIA and is a member of the global stewardship committee of the International Corporate Governance Network (ICGN).

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