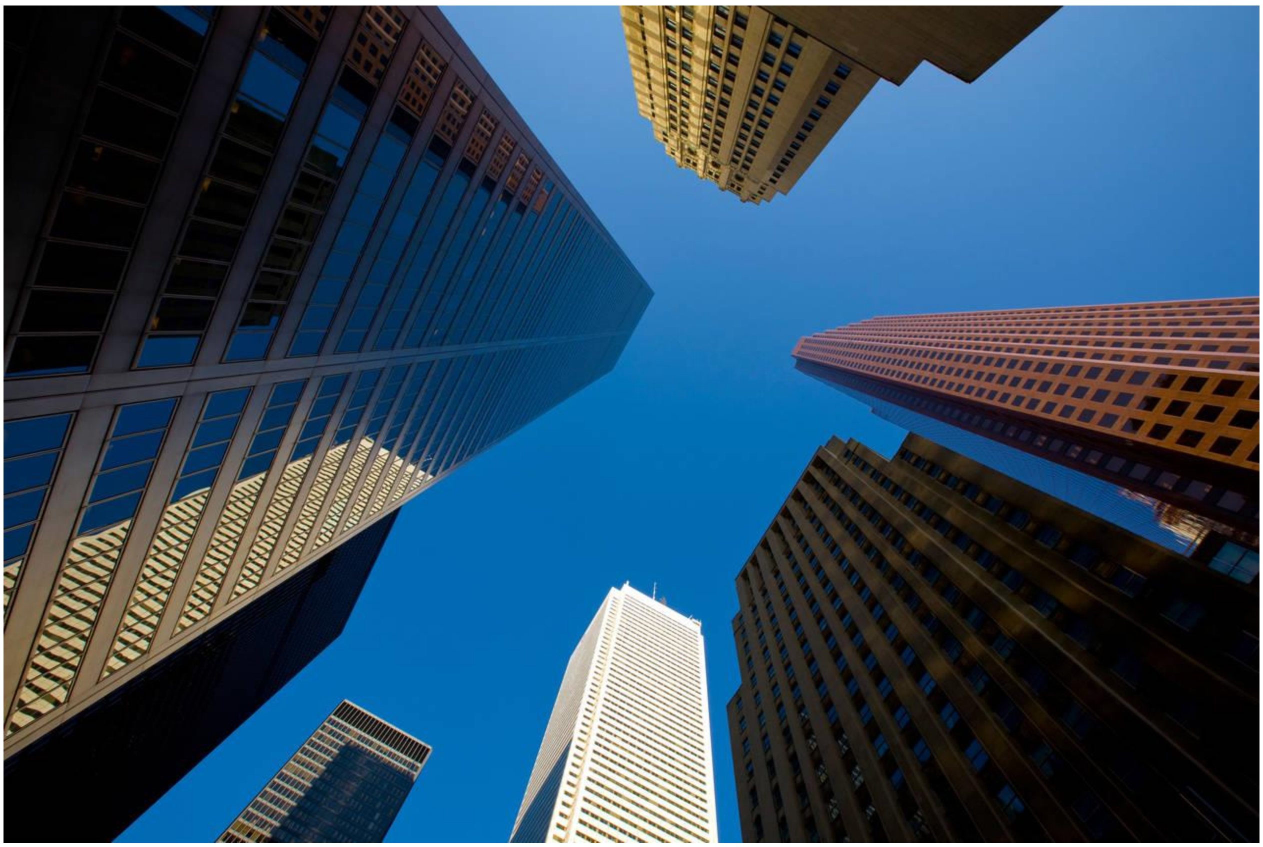
BARRON'S

June 24, 2017

Why Do Canadian Stocks Keep Blowing Up?

U.S. hedge funds are making a bundle betting against Canadian shares. Call it The Great White Short.

By BILL ALPERT

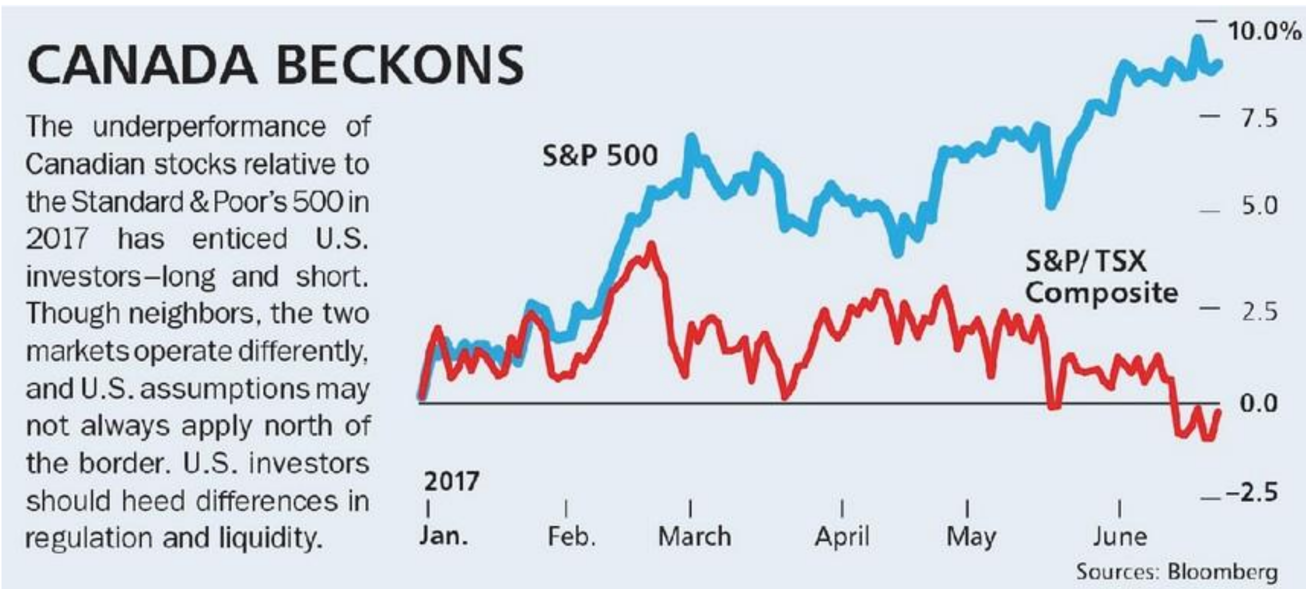


The view from Bay Street, the heart of Toronto's financial district. *Design Pics Inc/Alamy Stock Photo*

Toronto's Bay Street financial area seems like a cleaner, quieter version of Wall Street. The country's six big banks passed relatively unscathed through the financial crisis. The local bourse's TSX index has moved more or less sideways, while U.S. markets bubble up. Canada's economy grew at 3.7% in this year's first quarter, and the world has a crush on Prime Minister Justin Trudeau. With resource and energy companies finding their footing again, U.S. investors might be tempted to prospect above the border.

It's not as quiet as it looks. A number of Canada's highflying growth stocks plummeted over the past couple of years, amid the kind of skepticism that shows in tallies of shorted shares. The big mortgage lender Home Capital Group (ticker: HCG.Canada) dove from 30 Canadian dollars (US$22.70) to C$6 this year, creating an opportunity for Warren Buffett to scoop up discounted shares in a C$2.4 billion rescue deal announced last Wednesday. In May, Calgary-based ditchdigging service Badger Daylighting (BAD.Canada) fell from C$35 to C$22, before recovering to C$26. Valeant Pharmaceuticals International (VRX.Canada) took up domicile in Quebec, before its shares peeled from C$335 to C$18. Concordia International (CXR.Canada), an Ontario pharma outfit that aped Valeant's high-price drug strategy, saw its own shares plunge C$103 to C$1.50.

Were these good Canadian stocks hosed by aggressive Wall Street tactics, or did researchers uncover what the market had missed? You might think the former from reading our northern counterpart, The Financial Post, where a columnist recently blamed Home Capital's near collapse on a conspiracy of lying Yankee short sellers and overbearing Ontario regulators. The mortgage firm was shorted and the subject of long-running critiques by Marc Cohodes, a retired U.S. hedge fund manager whose television and Twitter comments about Home Capital were labeled outrageous "bulls___t" by FP columnist Terence Corcoran—in a piece written before Home Capital admitted and settled allegations by the Ontario Securities Commission that the lender had misled shareholders about its mortgage underwriting.



A Winnepeg-based company, Exchange Income Corp. (EIF.Canada), is worried it's become the latest target of short selling (see "Is Exchange Income a New Target for Short Sellers?").

As a private investor who's happy to talk on the record, the 56-year-old Cohodes looms larger in the minds of Canadian pundits than the big institutions whose long and short sales really drive stock prices. After decades of jawboning U.S. stocks he deemed overvalued—often correctly—Cohodes seems to have found a bully pulpit in Canada. He created a pop-up website to air his views on Badger Daylighting and teases Twitter followers about possible upcoming short ideas. When we asked him why he's picking on Canada, he said that local investors and regulators have ignored its problems. "When you've got a dental drill and you keep finding tooth decay," he said of his work, "you keep going."

Hanif Mamdani, who runs a $1.6 billion hedge fund at RBC Global Asset Management in Vancouver, offers a different view. "Canadian markets are probably less efficient than markets in the U.S.," he says "The nature of money in Canada is not as sophisticated." That said, he warns that many Yanks mistakenly bring their U.S. assumptions with them when they wade into Canada's waters.

Others list more-systemic reasons for Canada's market having had a run of recent investment kerfuffles. Among them: Provincial securities regulators have been more indulgent than their U.S. counterparts; Canadians' home bias favors domestic issuers; “group think” sometimes prevails in the country’s small clique of investment banks; and when U.S. money pours in and out, illiquid Canadian stocks go to extremes.

These are valid concerns for U.S. investors and persuaded Anthony Scilipoti and his partners to start ***Veritas Investment Research*** 17 years ago in Toronto, where the forensic accounting shop is a lonely domestic voice of skepticism. “We’re happy as Canadians to have foreign investors put their money in our equities,” he says, “but we’re not happy when they criticize us. It’s quite comical.”

SHORT SELLERS STARTED looking north in large numbers several years ago, seeking bets against the rising price of residential real estate in Toronto and Vancouver, in an investment fad that came to be known as The Great White Short. That housing bubble still hasn’t burst and the much shorted shares of Canada’s big six banks have generally held fast. The Home Capital investment announced on Wednesday by the Columbia Insurance subsidiary of Buffett’s Berkshire Hathaway (BRK.A) would seem to draw a line under The Great White Short, albeit at a low price.

The Berkshire unit will provide Home Capital with a C$2 billion line of credit, well secured and at a nice 9.5% interest rate. Pending approval, the Berkshire unit will also acquire up to 38% of Home Capital’s stock. The initial purchase at C$9.55 a share was 15% below market when Berkshire first bid, said the companies in their announcement, but ended up representing a 34% discount when Home Capital’s stock rose on its June 14 settlement with the Ontario Securities Commission, in which the lender acknowledged its failure to disclose mortgage fraud problems.

The Great White Short bet against Canada’s banks has always been a mistake, says RBC’s Mamdani. That belief is shared by Peter Mann, who heads equity investing at Toronto wealth manager Gluskin Sheff + Associates. The country’s six big banks— Bank of Montreal (BMO), Bank of Nova Scotia (BNS), Canadian Imperial Bank of Commerce(CM), National Bank of Canada (NA.Canada), Royal Bank of Canada (RY), and Toronto-Dominion Bank (TD)—don’t compete much for deposits. Canada avoided the nonrecourse loans and subprime securitizations that contributed to the U.S.’s 2008 meltdown. Home prices in Canada have risen, says Mann, but remain more affordable than most. “There might not be much, if any, appreciation remaining in residential housing in Toronto,” he says, “but the notion that it must decline 15% just because it went up 30% is not a rational argument.”

Scilipoti and his accounting colleagues at ***Veritas*** were early critics of the business models at Home Capital and Valeant. Scilipoti warns that extreme mispricings can occur in Canada when deep-pocketed U.S. investors overwhelm a long or short idea.

So investors must beware when placing Canadian bets based on American experience. Do your homework, eh?