ROE REPORTER

Stocks for the decade

The 2010s have come to an end and we have found ourselves both reflecting on the past and thinking of the future. 2019 was another solid year for DKAM. The Capital Ideas Fund returned 19.24%[1] for the year and has achieved a 17.23%[1] annualized return over the last 12 fiscal years. That's more than a decade of performance we're pretty proud of.

2019 was an interesting one. It seems that we had more confidence in the markets than did many of our peers. While we were re-opening the Capital Ideas Fund and expanding our mandate to include US investments, many of our friends were more bearish. Heading into 2019, there was not much optimism among "expert" stock market forecasters. The market consensus was for low single-digit gains, which ultimately proved to be incorrect.

With 2019 now in the rearview mirror, we remain relatively bullish. We are still confident in the quality of our investments and the state of the markets, and anticipate a similar pattern throughout the year. We believe investors will be pleasantly surprised with what lays ahead.

Like most of you, we've been watching, reading and listening to a variety of "decade in review" type pieces. In addition to re-visiting the top films and TV shows and best moments in sports (it's hard to believe the gold medal hockey game in Vancouver was 10 years ago) we've also been reviewing the top stocks of the decade.

One article in particular caught our eye. This was the *Globe and Mail*'s review of the performance of the S&P/TSX stock index, "This just wasn't your decade, TSX." Most of the article focused on Canada's stock market underperformance versus the US stock market. The article referenced how the Canadian benchmark index is now the cheapest that it has been "in decades," relative to the US index. Though this was generally a pessimistic story, we thought the most fascinating aspect of the article was a table of the S&P/TSX Composite *top* performers (Figure 1).

Figure 1.

S&P/TSX Composite top performers

Total returns since Dec. 31, 2009

Air Canada	**3,662.1%**
Boyd Group	3,443.7%
Constell. Software	3,344.7%
Kirkland Lake Gold	2,077.8%
Shopify	1,567.3%
Couche-Tard	1,129.1%
Dollarama	1,107.9%
Cargojet	1,023.7%
Enghouse Systems	969.1%
InterRent REIT	921.3%
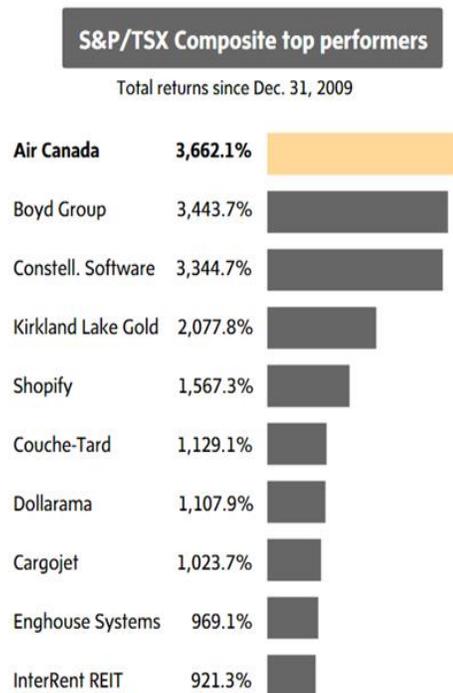
Now there are a few important points to note about the companies on this list. Two companies on the list didn't go public until halfway through the decade. Both Kirkland Lake Gold and Shopify went public in 2015 and saw their stocks soar since that time. Shopify is also the only one on this list that wasn't profitable during the decade. We categorize Shopify as a "unicorn" that went public at a $2.5B+ valuation in 2015. Adjusting for these two companies with a half decade of results, we took the stocks from the Globe and Mail article that had at least 10-year track records and analyzed their performance in more detail below. There are a few qualities that these companies had in common.

Figure 2.

Top Performing Stocks in S&P/TSX Composite					
Company	Industry	Market Cap 2009 (M)	Market Cap 2019 (M)	Average ROE	Earnings CAGR
Air Canada	Airlines	$ 367	$ 12,846	5%	48%
Boyd Group	Commercial Services	$ 66	$ 3,941	23%	27%
Constellation Software	Software	$ 738	$ 26,724	32%	24%
Alimentation Couche	Retail	$ 3,413	$ 35,828	23%	22%
Dollarama	Retail	$ 1,472	$ 13,934	29%	27%
Cargojet	Transportation	$ 53	$ 1,400	9%	11%
Enghouse	Software	$ 214	$ 2,636	24%	23%
InterRent	REITS	$ 42	$ 1,892	16%	16%
Average		$ 796	$ 12,400	20%	25%

Source: DKAM & Bloomberg

The fact that profitability is important to long-term gains isn't exactly a revolutionary statement. 7 of the 8 were profitable every year of the entire decade. Air Canada went through a turn-around in 2013-2014 and became profitable. This is when the positive performance of the stock began. What is more interesting to us is how profitable the vast majority of these companies were. Notice how the long-term average of earnings growth coincides well with the long-term return on equity ("ROE"). This is the main reason we believe ROE is such a powerful metric and the best way to look for compounders. Having a high and stable ROE signals that these companies have a defendable competitive advantage. Earnings growth can be volatile year over year, and especially quarter over quarter. These companies used their "moats" to grow the underlying

value of their business in a steady manner (effectively at the rate of their ROE), and investors who held for the long term were rewarded handsomely.

A second point worth noting is the size of these companies in 2009. The average market cap in 2009 was $796 million. This is definitely on the small side and many of these stocks would not have met the minimum size requirements for most investors in 2009. We think this is where a lot of the opportunities are, hence why it is important to be open to investing in small companies. Every big company was at one point a small company. Looking back over the trajectories of these companies over the last 10 years shows that strong growth is definitely possible.

It is also important to note that you don't need to own all of these companies in order to outperform. While it may be easy to look at a list and only think of the opportunities that were missed, we think that it is more important to consider all those companies that you did own. You will never be able to pick all of the winners, nor will you ever be able to avoid all the losers, but if you can put together a portfolio of high quality companies, you will have a better chance to own a basket of winners and to outperform.

Stocks for the *next* decade

When we look back over the past decade, it is fascinating to see just how much some of our top picks from 2010 have grown. Constellation Software, Boyd Automotive, and Paladin Labs come to mind. As we head into the 2020s, it raises the question, "Which companies do we think will become the big winners in the next decade?" While we expect these companies will once again come from many sectors and industries, the sector that we think will produce a disproportionate number of winners is…drum roll…the Canadian software industry!

Figure 3. – Constellation Software exemplifies the Canadian software industry and the type of stock we're looking for.
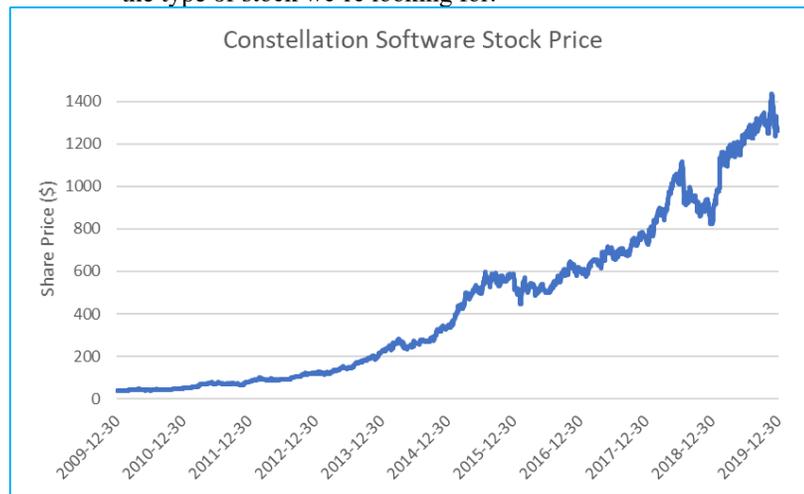
Source: Bloomberg

So why does the software industry excite us so much? First, of the roughly 50 Canadian software companies we track, 21 have bottom-line margins greater than 10% and 10 have margins greater than 20%. Proportionately speaking, there is no other industry in Canada that has that many highly profitable companies.

In order for a company to compound at a high rate of return, it must have a product or service it can sell which has a healthy profit margin. Once those profits are made, the management team must be adept at taking those profits and redeploying them quickly and intelligently so as to maintain both a healthy profit margin and the growth rate. Sound easy? It's not.

In addition to profitability, the software industry also has an outstanding growth profile. Companies typically grow by 1) expanding their sales organically by adding more products, sales people, and/or locations; or 2) by acquiring similar companies. Many companies do both. In the case of most software companies that we follow, there are ample opportunities to grow through either strategy.

Because software is still a young industry, the market doesn't require significant demographic growth to propel revenues higher the way the furniture or supermarket industries do. Most software companies are creating new products and services, whereas most mature industries are attempting to grow into largely satiated markets. In addition to the youthfulness of the market, many segments of the software industry are also ripe for consolidation. Thus, for many companies, acquiring smaller competitors is a more cost-effective way to grow quickly. Some of the fastest growing software companies in Canada over the past decade have grown primarily through acquisition. These include Constellation Software, Open Text, Descartes, and Enghouse.

Figure 4.

High Margin Canadian Software Companies			
	Cash	Market	P/Sales
Company	Margin	Cap (M)	Ratio (X)
RIWI	46%	$ 41	7.9
Sylogist	38%	$ 227	5.9
Namsys	34%	$ 24	4.9
Computer Modeling Group	33%	$ 647	8.5
Descartes	29%	$ 4,872	11.0
Open Text	27%	$15,701	4.2
Absolute software	26%	$ 375	2.7
Enghouse	23%	$ 2,856	6.6
Constellation Software	20%	$28,103	5.2
Jemtec	20%	$ 5	2.0
Information Services	19%	$ 266	2.0
Destiny Media Tech	19%	$ 14	2.7
ADCORE	18%	$ 25	1.6
Kinaxis	17%	$ 2,751	11.0
Quorom Info Tech	15%	$ 90	2.6
Ackroo	15%	$ 14	2.4
Air IQ	15%	$ 8	1.5
Altus	14%	$ 1,560	2.8
VitalHub	13%	$ 25	1.9
Optiva	10%	$ 276	2.3
Mediagrif	10%	$ 99	1.4
Average		$ 2,761	4.3

Source: DKAM

If we look back at the best performing companies of the past decade, we note that the typical stock has a market cap of less than a billion dollars. Thus, while we expect large software companies to continue prospering, the big winners in the coming decades will likely come from companies with market caps of less than a billion dollars, that trade on reasonable valuations, and have relatively high margins. While we don't own every software as a service (SAAS) company presented in Figure 4, we do own a lot of them and track this sector more closely than any other in Canada.

Not all of these software companies will successfully develop into long-term compounders. Each one will face its own challenges and difficulties. So what is it that we look for in selecting our stocks for the next decade?

Similar to where the top performers of 2010 started, you'll notice a bias to smaller companies, as well as profitable businesses with long runways for growth. The list is roughly half software businesses (no surprise) and entirely made up of high ROE companies. We believe these stocks are well on their way to being *the* stocks to own in the 2020s due to their high ROEs, margin profiles, and competitive advantages.

Figure 5.

Stocks for the next decade			
Company	**Industry**	**Market Cap (M)**	**ROE**
Spin Master	**Toys/Games/Hobbies**	$ 4,032	20%
Colliers	**Commercial Services**	$ 4,013	33%
Enghouse	**Software**	$ 2,780	24%
Goeasy	**Diversified Finan Serv**	$ 1,015	21%
Tucows	**Internet**	$ 839	26%
Xebec Absorption	**Miscellaneous Manufactur**	$ 189	27%
Sangoma	**Telecommunications**	$ 173	19%
Quorum Info Tech	**Software**	$ 90	24%
RediShred	**Commercial Services**	$ 65	18%
Adcore	**Software**	$ 27	26%
Vitalhub	**Software**	$ 25	17%
Namsys	**Software**	$ 23	29%
Average		$ 1,106	24%

Source: DKAM

Over the next decade there will no doubt be more unicorns and gold or energy discoveries that lead to massive gains. However, we have no feel for how to pick which of these may be winners. We remain committed to our strategy of careful and methodical quantitative analysis to find the best high-quality companies with steady compound growth.

Final thoughts

Looking ahead through the lens of the businesses in which we invest, there is a lot more to be optimistic about than pessimistic. There will continue to be small businesses that grow into large businesses, the compounding effect will continue to work its magic, and those invested will continue to reap the rewards.

This newsletter for January 2020 not only represents our first newsletter of the new decade but it is also the 50th edition of the *ROE Reporter*. We thoroughly enjoy having an outlet to share both our ideas and information on the Capital Ideas Fund. We hope to have the opportunity to write 50 more.

As always, we would like to thank the entire Donville Kent family, including all of our investors and employees. If you would ever like to discuss any investment related topics, always feel free to reach out.

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All estimates, projections, and calculations have been generated by DKAM. This does not constitute advice for personal investments but rather a breakdown of how Donville Kent approaches stock analysis.

1 Time weighted rates of return for Class A Series 1, net of all fees and expenses as of December 31st, 2019.
2 Tim Shufelt. (December 20, 2019). *This just wasn't your decade, TSX. Here's why the next 10 years looks more promising*. https://www.theglobeandmail.com/investing/markets/inside-the-market/article-the-canadian-stock-market-enters-the-2020s-with-signs-of-promise/

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