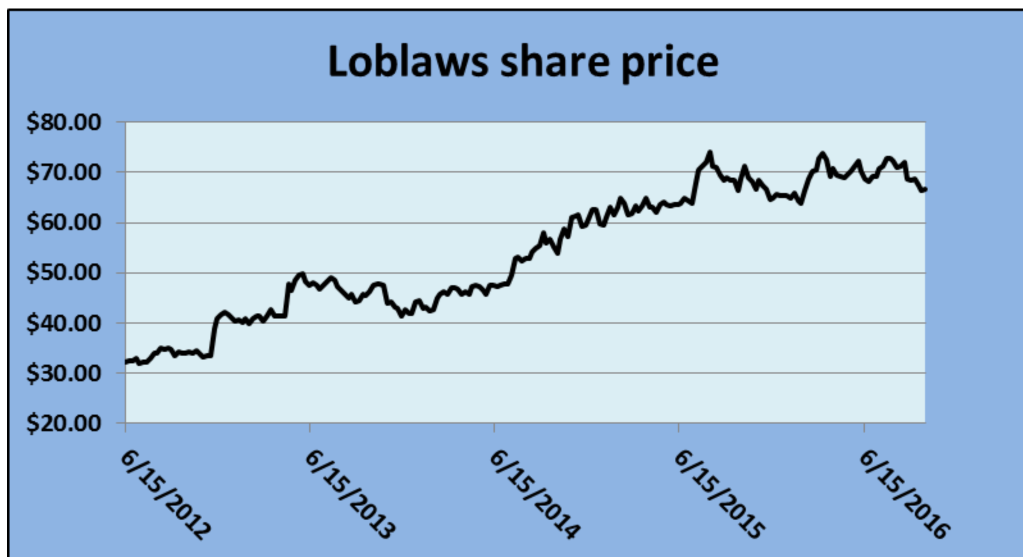
Market Commentary
Third Quarter 2016

Harbour Fund
Harbour Global Equity Corporate Class

The good news: everyday low prices are coming to a grocery store near you.

The bad news: After a great multi-year run, everyday low prices are also going to hit Canadian grocery stocks.



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Is grocery a good business? To jump to the conclusion, we think not. We also believe that a day of reckoning for the sector is at hand as severe headwinds are gathering momentum. Like other sectors that have enjoyed multi-year outperformance on the back of perceived stability, valuations are stretched and investors have become far too complacent. Under new management, Harbour Fund has reduced exposure to the sector from 8.5% to zero.

Let us consider the sector from a Harbour process perspective, which simply focuses on four key questions:

1. Is this a high-quality business?
2. Is the balance sheet in good shape?
3. Is management a good steward of capital?
4. Why is the business mispriced?

Business quality
The revenue of a typical grocer has historically been quite stable. After all, no matter what is going on in the broad economy, consumers keep buying bananas (by far the largest-selling item in a grocery store, it turns out). Demand is very inelastic.

A lot happens, however, between the revenue line and the profit line. Stocking fresh chicken in every far-flung grocery store across a massive country like Canada is apparently a hard thing to do. Profit margins are therefore extremely low, leaving very little room for external shocks or operational error.

If we look at some of our other sniff-test metrics for good businesses, such as return on invested capital (ROIC) or return on equity (ROE), we get a less than perfect picture. With the notable exception of Metro, it is debatable whether other Canadian grocers actually earn their cost of capital on a regular basis.

Despite some differences in customer in-store experience, grocers are mostly selling a commodity, leaving the business open to aggressive price competition. In Canada, this has historically been kept in check due to the oligopoly nature of the market.

Overall, we rate the sector below average in terms of business quality.

Balance sheet
Overall, balance sheets are in good shape across the sector.

Management quality
Management has a pretty good record throughout the sector with the exception of Empire (Sobeys), which has somehow managed to write down a staggering $2.9 billion of its $5.8 billion purchase of Safeway Canada in 2013.

Is the sector mispriced?
In our opinion, these businesses are absolutely mispriced – they are overvalued. What follows are some details on why we think that this is the case.

Short-term concerns
Over the past decade, Canadian grocers have been slowly and consistently losing market share to Walmart and Costco, which combined now make up 20% of the Canadian market. This trend is unlikely to reverse. Note Walmart Chief Financial Officer Brett Biggs' comments on the company's second quarter conference call:

"In Canada, ***despite increased promotional activity by competitors throughout the quarter***, comp sales increased 1.1%. Comp sales have now been positive for nine consecutive quarters. ***And according to Nielsen, we continue to gain market share in food and consumables and health and wellness."***

Elevated food inflation (partly driven by a falling Canadian dollar) has masked these challenges over the past two years, supporting growth for the Canadian grocers. Unfortunately, this benefit is now behind us and signs of slowing food inflation, and possibly even deflation, are becoming apparent. You only have to look to the U.S. and Europe to get concerned about these trends with the likes of Tesco, Carrefour, and Whole Foods trading at a fraction of their previous market values. With the tailwind of the falling Canadian dollar behind us, or at least fading, it is unlikely that Canada will continue to escape the deflationary fate of our neighbours.

Long-term concerns
It's not just the near-term problems that worry us. Longer term, possible new German entrants as well as Amazon pose even more severe headwinds. The German players have already wreaked havoc in many markets around the world, a fact that seems unknown or underappreciated by the average Canadian investor.

The Germans we're talking about are two food retailers, Aldi and Lidl. For those of you not familiar with these two companies, they're hard discounters. That is, they compete aggressively on price and have designed their entire business to be systematically cheaper than traditional food retailers. Some studies have concluded that these players are undercutting Walmart in the U.S. market by 30-40%!

Many Canadian investors are quick to dismiss this threat, pointing to Target's lack of success in Canada. But as leading management consultant firm Oliver Wyman pointed out, Target is an example of a company whose failure was self-inflected. Lidl, on the other hand, has successfully navigated and entered 28 different markets. From Oliver Wyman's standpoint, it's not a question of whether these hard discounters will come to Canada, but rather when – they see it as inevitable.

The second challenge, and one that will likely take much longer to play out in Canada, is disruption from online grocers. For now this is not significant and that gives Canadian grocers time to position themselves. But you only have to look at markets such as the U.K., where online grocery has taken off, to become concerned about the potential consequences. There are many challenges involved in launching an online offering, not the least of which is a lack of profitability, cannibalization of existing stores, and head-to-head competition with Amazon, a business which only aims to break even.

Valuation
Our concerns do not match up with current sector valuations which are still high relative to historical averages and are at big premiums to global peers. We believe that this high valuation reflects past stability and growth as opposed to troubling future prospects. We think that the current "buy" investment thesis – which is often nothing more than saying, "These companies always seem to figure it out" – is on shaky ground, hence our 0% weighting to the sector across the entire Harbour group.

Elsewhere in the equity portfolios…
We have made significant changes to the portfolios over the last two quarters. We have also made several additions to the Harbour team and implemented a new process and new risk controls. With these foundations now in place, we have been able to act decisively in the portfolio.

Currently, Harbour Fund has 42 holdings and Harbour Global Equity Corporate Class has 32. The number of holdings in Harbour Fund is somewhat higher mostly due to the more diversified approach that we have taken towards the energy and resource sectors.

Many names have exited the portfolio as they did not meet our investment criteria. Included in the deletions over the last quarter were George Weston (what remained of our grocery exposure), Honeywell, Gildan, CVS Health, Secure Energy, Element Financial, Dollar General, Phillips, Schneider Electric, CRH, and Wells Fargo (which was replaced with two high-quality U.S. regional banks).

We added to favoured names, including Oracle, Symantec, and Apple, and also initiated a new position in Twenty-First Century Fox. As you can see, we sold more than we bought. This has increased cash balances across the funds to just under 20% in Harbour Fund and approximately 23% in Harbour Global Equity Corporate Class.

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We have taken a middle of the road approach with currency. Half of our U.S. dollar exposure is hedged in Harbour Fund and 30% in Harbour Global Equity Corporate Class.

With the significant changes that have been made over the last two quarters, we are confident that the portfolios have been brought in line with client expectations. That is, we own high-quality companies at very reasonable prices. Should markets take a turn for the worse, we think that the overall defensive posture of the funds will provide the protection that clients look for when they invest with Harbour.

Thank you for your continued support.

Ryan Fitzgerald, CFA
Senior Portfolio Manager

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