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THE GLOBE AND MAIL

All dried up: How Bay Street cashed in on the cannabis frenzy before the carnage

Mark Rendell and Tim Kiladze
November 1, 2019

The warning signs were there all summer, but it wasn't until the first business day of September that the reckoning arrived for Canadian cannabis companies in need of money.

After markets closed on Sept. 3, Aurora Cannabis Inc., one of Canada's largest legal marijuana producers, tried to sell its 10.5-per-cent stake in a rival company, The Green Organic Dutchman Holdings Ltd. – better known as TGOD – to public investors.

After two days of marketing, roughly half of the $86.5-million in TGOD shares remained unsold, according to sources familiar with the sale. TGOD had been an investor favourite and the deal was priced at a 14.5-per-cent discount to the market, but buyers still balked.

At the time, there were already clear signs that the days of easy money for cannabis companies were over. The total amount of money raised by the sector had plunged over the summer. But the TGOD deal sent a message to the entire industry: The taps were almost fully closed.

With little access to fresh cash, Canada's licensed producers now face a new reality. They have spent years focused on financings to fund their expansions, paying little mind to positive cash flow. Without new capital, they will have to scrap construction projects and scale back growth plans. Or worse.

"The vast majority of the companies are going to go bankrupt," said Igor Gimelshtein, the former chief financial officer of MedReleaf Corp., which was sold to Aurora Cannabis Inc. in 2018 for $3.2-billion. He is a partner at Toronto-based Zola Global Investments, which invests globally in the cannabis industry.

In September, independent investment bank Mackie Research Capital Corp. calculated that nine companies had less than six months worth of cash available to fund operations. The figure jumps to 21 companies after adding capital expenditures. A few weeks later, TGOD shelved plans to finish a 1.3-million-square-foot greenhouse facility in Quebec, and it is seeking bridge financing just to keep the lights on at a smaller operation in Ontario.

In this environment the share prices of many cannabis stocks have been eviscerated, and executives face painful options: fire sales, shotgun mergers, radical downsizing or bankruptcies. Even the largest producers are selling off assets and taking on expensive financing to ride out the bear market.

In the past two weeks, Canopy Growth Corp. and Aphria Inc. have both sold stakes in Australian cannabis companies. Late last month, Hexo Corp., Quebec's largest cannabis grower, announced it is shuttering one of its greenhouses and laying off 200 staff.

Amid the rout, cannabis executives are taking it on the chin, and some, including ex-Canopy chief executive Bruce Linton, have been ousted.

Bay Street, however, has largely evaded blame – even though the industry was built on the terms it set. The cannabis bubble was fuelled by stock promoters, hedge fund managers, investment banks and law firms that have helped raise close to $8-billion from public investors since 2017, and have clipped hundreds of millions of dollars in fees in the process.

With the money pouring in, cannabis executives made outlandish predictions and inked expensive deals with few repercussions. Of the industry's many problems, "the biggest one is the lack of intellectual integrity," Mr. Gimelshtein said.

For all the money they made, the industry's original financial backers have now largely moved on to more promising U.S.-based companies, or are out of the sector altogether. Retail investors are still heavily invested, holding 80 per cent or more of many cannabis companies' shares.

As with so many bubbles, much of the smart money got out early, leaving behind retail investors who clutch shares with dwindling values – with little hope of recouping big losses.

LAYING THE FOUNDATION

When the federal Liberals came to power in 2015 with the promise of legalizing and regulating recreational cannabis, they touched off a stock market frenzy. To many investors, it was a once-in-a-lifetime opportunity to become the new-age alcohol barons, and licensed producers soon began trading on the TSX Venture Exchange and the Canadian Securities Exchange.

Amid the hype, no one seemed to care how realistic business plans were; actual legalization was still some distant event. It was the perfect environment for stock promoters, many of whom had been starved of oxygen after the junior miners and junior energy companies they touted in the early 2000s, and again after the Great Recession, collapsed after commodity price downturns.

These promoters prowled the country looking for early-stage cannabis companies to take public, typically by merging them with a dormant mining shell company still trading on the TSX-V or CSE.

It was a tried-and-true formula. Much like in mining booms, promoters would sell a publicly traded shell to a private cannabis company, then take cheap shares in the new public entity. As a condition of the merger, the cannabis company would also pay for stock promotion, using third-party “investor relations” firms to produce online posts and videos directed at unsophisticated retail investors.

Cannabis companies would routinely pay tens, even hundreds, of thousands of dollars for a few months of promotion. One company, Wayland Group Corp., formerly called MariCann Group Inc., paid investor relations firms more than $4.5-million in 2018 – half in cash, half in shares.

One investor relations specialist, who spoke on the condition of anonymity, estimated that at least half the cannabis companies that went public on the CSE were never built to survive long-term as real businesses. They were vehicles that promoters could use to make quick money, and then bail.

Compared with prior booms, promoters didn’t have to work all that hard, either. Many baby boomers and millennials are passionate about cannabis. Millennials were also often new to investing, so they had never experienced a downturn. All they saw was upside potential.

In other words, they were fresh meat.

“It’s been really distressing to watch, because I’ve seen a lot of bad corporate behaviours [and] gross disrespect for shareholder money,” said Jeannette VanderMarel, who co-founded TGOD but sold a controlling stake in the company to a group of investors in 2017, when it was still a small, private greenhouse operation. “A lot of it has been shameless self-promotion without any viable products to sell.”

Yet, as cannabis stocks soared, detractors found themselves screaming into the wind. To the surprise of everyone, U.S. beverage giant Constellation Brands Inc. bought a 10-per-cent stake in Canopy in October, 2017, for $245-million, and pot stock prices soared after. Here was real money from an established company justifying all the hype.

BUILDING THE BUBBLE – ON BAY STREET’S TERMS

The cannabis boom was an investment banker’s dream. With so much retail investor demand, it was easy to underwrite share sales – and to dictate the terms of the game.

Because licensed producers weren't generating much revenue or cash flow, the mantra when selling deals was "funded capacity." The formula: Take the value of cash on a producer's balance sheet and multiply it by the amount of land it owned and the amount of cannabis per square foot it hoped to grow. Little attention was paid to the quality of marijuana or the challenges of building a viable business.

"Companies were just rushing for scale," said Aaron Salz, principal with Stoic Advisory Inc., a cannabis capital markets advisory firm. "That wasn't optimized for success with consumers. It was more optimized for success in the capital markets."

It became a speculative circle. The more money a producer raised, the more it was worth – which helped it raise even more money. Aphria Inc., one of the first out of the gate, raised $305-million from four share sales in 2017.

Mergers and acquisitions were also rampant. In early 2018, Aphria agreed to purchase Nuuvera Inc. for $826-million, even though Nuuvera had gone public only four weeks earlier.

For the first several years, the Big Six Canadian banks were too timid to touch cannabis for fear of running afoul of U.S. federal laws. That left the sector wide open to smaller independent investment banks such as Canaccord Genuity, Eight Capital Corp., GMP Securities Inc. and Clarus Securities.

At Canaccord, cannabis dominated its Healthcare and Life Sciences division, and this unit brought in $267-million in investment banking revenue in fiscal 2018 and 2019 combined.

Little known to outsiders, the key to much of this fundraising was a small group of Toronto hedge funds – notably MMCAP International, Anson Funds and K2 & Associates. They figured out how to cycle money through deal after deal, with relatively little risk.

When a brokerage had a large cannabis offering to sell, the hedge funds would buy in. In one example, when Hexo raised $150-million in January, 2019, MMCAP scooped up $75-million, according to a buyer's list obtained by The Globe and Mail.

However, the funds often were not buying shares to hold them. They were using sophisticated financial tricks to get out quickly at a profit.

One tactic involved short-selling, a strategy used to bet on a falling stock price. Financings are usually issued at a discount to market prices in order to attract buyers. But hedge funds anticipating a new cannabis deal could short the issuer's shares before the deal launched. They then covered their positions by purchasing large portions of the financing. In effect, the hedge funds could instantly earn the discount percentage.

These transactions were frequently aided by cannabis company insiders, who would help the hedge funds short their company's stock by lending shares they owned. All three funds either declined to comment for this story or did not return a request for comment.

"The guys who were doing most of the bought deals weren't bringing in real buyers," said Anthony George, head trader at independent investment bank Infor Financial Group. "Most of the orders on these deals were guys that were short … They were providing liquidity, but they were turning over the same paper."

The financial wizardry, while legal, created the impression that producers were attracting long-term institutional investors. In reality, the smart money was often out the door before a financing even closed.

THE INEVITABLE BUST

Canada's cannabis fever started breaking in mid-2018, under the weight of warnings about ridiculous valuations, bad deals and aggressive stock promotion. Yet, the sector caught a second wind after Constellation invested $5-billion more in Canopy that August.

HMMJ, an exchange-traded fund that tracks publicly-traded cannabis companies, jumped 79 per cent in two months. And then recreational legalization came off as announced on Oct. 17.

But the market downfall that followed was almost as swift. Mere months after legalization, product shortages were rampant and legal retail stores were still scarce. Canopy reported a $323-million quarterly loss in June, and two weeks later Mr. Linton, the one-time face of the Canadian industry, was fired.

Soon afterward, CannTrust Holdings Inc. was found to have grown thousands of kilograms of cannabis in unlicensed parts of a greenhouse in Ontario, leading Health Canada to suspend the company's licences. With all the commotion, demand for new financings dried up and stock prices collapsed.

The current debacle, though, runs deeper than simple investor fatigue. The woes are structural.

Throughout 2018, a stampede of cannabis deals chased a limited pool of money – a trend that was exacerbated by a new wave of U.S.-based companies that went public in Canada. Smart money shifted south, where legal cannabis markets in several states are thriving and federal recreational legalization is looking increasingly likely.

"It became pretty obvious to us that there just wasn't the institutional capital that could support these [Canadian] deals," said Mr. George, the trader at Infor. The same was true for daily trading. “When a stock would correct 10 per cent all of sudden, there was just no one there to stop it.”

On top of that, a lot of money remained trapped in private companies. Many of them raised startup capital in 2017 and 2018, with the hopes of going public. That would allow early investors to exit at a profit. Now, however, Canadian IPOs are off the table.

Worse, assets held by those private companies have lost value. Not long ago, a standard Health Canada cultivation licence had a market value between $50-million and $100-million, Mr. George says. But Health Canada keeps issuing more licences – 245 growing or processing licenses so far – and each one is now worth less than $10-million.

Starved of cash, one option for the sector is to consolidate. However, mergers are hard to pull off when balance sheets are littered with landmines.

For one, many companies have loads of warrants outstanding. Warrants are similar to stock options, allowing holders to buy shares at a preset price in the future, and they are often offered to cannabis investors as a sweetener when raising money. At the moment, many of these warrants are worthless because market share prices have plummeted. But if share prices rebound, the warrants could severely dilute the ownership of existing shareholders.

Convertible debt also hangs over much of the industry. As it became harder to sell straight equity, many producers turned to convertible debentures. This debt often allows the issuer to convert the securities to shares if the stock price rises, removing a liability from their balance sheet.

However, if the share price remains below the conversion price, the debentures have to be paid back in full.

Aurora, for example, issued $230-million in convertible debentures that come due in March, and the company can force conversion at $17 per share. Aurora’s stock closed at $4.69 on Friday.

In its recent analysis, Mackie, the investment bank, noted that eight cannabis producers have convertible debt that matures in the next 12 months.

“Companies may have to go back and reprice and renegotiate the conversion prices … creating a more significant dilution event than people maybe anticipated,” said Mr. Salz of Stoic Advisory.

SALVAGING WHAT’S LEFT

Cannabis producers are scrambling to adjust to the new reality. In July, Flowr Corp., a mid-sized B.C. grower, cancelled plans to raise $125-million and later settled for $43.5-million instead.

In late October, Vancouver-based Zenabis Global Inc. announced a $20.8-million rights offering that priced the shares 73 per cent below their market price. The company said this was the "least dilutive" way it could access capital, "given current market conditions."

Amid the shakeout, the investment banks that profited the most during the bull market are largely silent. Canaccord Genuity, Eight Capital and Clarus Securities all declined to comment for this story. However, GMP Securities CEO Harris Fricker responded.

"I don't think you can characterize the investment banks that were active here as a homogeneous group," he wrote in an e-mail. "The key players brought very different approaches to the underwriting market and this is very well known on the Street."

Independent investment banks also can't be singled out anymore. After staying on the sidelines early on, many large banks entered the cannabis sector in the past year. CannTrust's last financing before running into trouble with Health Canada was underwritten by foreign banks and Royal Bank of Canada.

Despite the shakeout, Mr. Fricker is still optimistic. "We continue to believe that this will ultimately be a huge international market anchored, inevitably, by the United States," he wrote. And like any consumer product, he added, a few key players will dominate.

Some smaller companies could also emerge leaner and stronger. That's what TGOD CEO Brian Athaide is hoping for.

"We would still make these choices [to postpone construction plans] because of market conditions," Mr. Athaide said, "even if we had sufficient cash to do the larger construction. From a business standpoint it makes sense: Why invest more capital before it's needed?"

But to win investors back, cannabis companies will need a new mindset: less cowboy mentality, more professionalism. Too many boards and executive offices were stacked with friends of the founders.

"Finding great talent is the next important phase for this sector," said Les Gombik, an executive recruiter. Yet hiring that talent isn't so easy any more.

"A lot of people entered the industry because it was exciting, and there was huge upside potential," Mr. Gombik said. Now, executives are confidentially calling his firm and asking for ways out. "It's not as much fun any more," he said.

The radical new reality may surprise retail investors who got burned. But the truth is, Canada has seen this all before. We are a country rife with commodity cycles.

If previous busts are any indication, there will be blood for many small cannabis producers. The TSX-V housed a lot of the junior mining companies that soared after the Great Recession and the index peaked in Feburary, 2011, but has since lost 78 per cent of its value. Once the growth financing disappeared, companies weren't valued on their potential; they were assessed on what they actually produced.

It is still too early to definitively say that cannabis is in the same spiral. This market has been volatile and there may be another upswing.

All producers aren't identical, either. A handful of companies with strong balance sheets and economies of scale "are ultimately going to be very successful," Mr. Gimelshtein said.

"But before that happens, a bunch of these companies are going to hit the wall."

THE GLOBE AND MAIL

Cannabis, crypto and connections: Wayland Group's shifting fortunes

Tim Kiladze and Mark Rendell
August 19, 2019

A warning sign of fresh trouble for Wayland Group Corp. came to light in late April. Once one of Canada's most promising cannabis companies, Wayland announced on April 23 that it likely wouldn't file its 2018 financial statements on time. A week later, it confirmed the delay, prompting the Ontario Securities Commission (OSC) to place a cease trade order on its shares.

For months, the company was quiet. But in the dying minutes of Friday, Aug. 2, as most of the country was settling in to a midsummer long weekend, Wayland sent out an unexpected news release.

Its chief executive had resigned, its auditor had quit – and there still weren't any financial statements.

Instead, Wayland announced a deal to sell its Canadian assets to a cryptocurrency company and revealed discussions to sell its remaining international business to ICC International Cannabis Corp., an early stage company built by junior mining financiers.

Altogether, the proposed deals and departures paint a landscape in which Wayland would effectively cease to exist. If the deals go through, the developments will mark an abrupt end for one of the first licensed commercial marijuana growers in Canada, a company that has faced operational problems, regulatory probes and criticisms of overly promotional activities.

Wayland plans to sell its Canadian assets, which include a production facility in Langton, Ont., to Cryptologic Corp. The buyer is a relatively small cryptocurrency miner that lost $74-million in fiscal 2018 after writing down two acquisitions. Until July 31, the company was known as Vogogo Inc., and at the time of its name change, management said in a news release that the "rebranding emphasizes the company's focus on cryptocurrency mining."

Two days later, Cryptologic offered to buy Wayland and to pivot to cannabis. Many of Cryptologic's backers come from the online gambling industry, where some helped build Amaya Inc. The name Cryptologic even appears to have been recycled: Cryptologic Inc. was an online gambling company acquired by Amaya in 2012.

Three Cryptologic shareholders – Yoel Altman, John Vettese and Craig Bridgman – were also shareholders of a private company called NanoLeaf Technologies Inc. that was acquired by Wayland in 2017 for $38.5-million in stock.

Cryptologic's takeover structure is complicated. The company has offered to pay for Wayland's Canadian assets by issuing 57.5 million of its shares at $4 apiece.

However, Cryptologic shares closed at $1.99 on the Canadian Securities Exchange on Friday, meaning the company is offering a theoretical value for its shares.
It is the same tactic that Green Growth Brands Ltd. used in its recent unsuccessful takeover takeover bid for Aphria Inc. In December, Green Growth proposed to acquire Aphria "based on a valuation of $7 a share" of Green Growth, yet at the time the offer was announced the buyer's shares were worth $4.98 each.

There is another parallel between the Green Growth and Cryptologic offers: Mr. Altman and Mr. Bridgman have ties to both companies. Mr. Altman has been a principal of Green Growth, and Mr. Bridgman has been a shareholder in the company, according to regulatory filings.

In an e-mail, Cryptologic CEO John FitzGerald said the offer price took into account that Cryptologic committed to providing Wayland with a bridge loan and to having cash available to fund the merged company's growth – implying that these developments will boost Cryptologic's value, and therefore its share price, in the long run.

He also said that, if the deal is completed, he will step down as CEO and the company will be run by current chief financial officer Jordan Greenberg, who cut his teeth in the cannabis space with Nuuvera Inc., a development-stage company that was acquired by Aphria only three months after going public.

As for the shareholders with ties to both the company that Wayland acquired in 2017 and to Cryptologic, Mr. Vettese, who is a corporate lawyer at Cassels Brock & Blackwell LLP, wrote in an e-mail that he "had no involvement whatsoever" in the proposed Cryptologic/Wayland transaction. "I first became aware of the proposed transaction after it was publicly announced," he wrote.

Mr. Altman and Mr. Bridgman did not return multiple requests for comment.
If completed, Wayland's other proposed deal, to sell the rest of its international assets to ICC, would see the company sell its majority stake in a business whose prized asset is one of only three companies licensed to grow medical marijuana in Germany.

Wayland already sold ICC a 49.9-per-cent stake in its international portfolio in an all-share deal that valued the stake in the portfolio at US$129-million when it was announced in January. Today, the shares Wayland received in return are worth US$19.5-million, after an 87-per-cent drop in ICC's share price.

Canadian-run hedge fund MMCap International Inc. was the largest shareholder of both Wayland and ICC in early 2019, according to regulatory filings. Its current position in both firms is unknown.

Both the ICC and Cryptologic deals are being negotiated against a backdrop of turmoil at Wayland.

On Aug. 2, Wayland disclosed that MNP LLP had resigned as its auditor, adding that MNP said “there is an unresolved issue … relating to the conduct of the company’s former CEO in respect of the audit of the company’s 2018 annual financial statements."

MNP did not elaborate on the matter, and the audit firm declined to comment for this story.

Asked about the unresolved issue, former CEO Ben Ward declined to comment, but in an interview he said he expects the audit to be completed in due course. He added that he has effectively been out of the company since June.

Wayland’s new CEO, Matthew McLeod, declined to comment for this story.

The development comes after a series of blows in 2017 and early 2018 that changed Wayland’s trajectory.

Licensed in 2014, the company, then known as Maricann Group Inc., was one of the first to receive approval from Health Canada to grow cannabis as part of the federal government’s commercial medical-marijuana system.

Yet in March, 2017, a windstorm hit the company’s Ontario production facility, destroying crops in two of its five greenhouses. At the time, Wayland was preparing to go public on the Canadian Securities Exchange, and it began trading in April, 2017, but the company did not disclose the damage done by the storm until months later, in September.

A few months later, in February, 2018, the company came under scrutiny from the OSC for failing to disclose to investors that Mr. Ward was the subject of an OSC investigation for his actions at a previous company.

The OSC also opened an investigation that month into two directors of the company – former chairman Julian Neil Tabatznik and Raymond Stone – who sold about $8-million worth of shares days before the company announced a $70-million financing in late January, 2018.

Both Mr. Tabatznik and Mr. Stone resigned from the board, and in early March, 2018, a syndicate of investment banks, led by Eight Capital and Canaccord Genuity, cancelled the financing altogether.

An OSC investigation into the two directors was closed in September, 2018, with no further action taken. The OSC investigation into Mr. Ward is continuing.

After the failed share sale, Wayland's stock price collapsed throughout 2018, and management spent heavily to promote the company. In 2018, Wayland paid investor-relations firms more than $4.5-million, half in cash, half in shares, to promote its stock. On three occasions that year the OTC Markets Group, which manages the over-the-counter trading platform where Wayland's shares trade in the United States, ordered the company to issue clarifying statements about misleading promotional material.

Mr. Ward dismissed any suggestions of wrongdoing. "I'd frame it as industry norm, industry standard," he said in the interview. "It's a way to get your message out and gain liquidity for investors."

Despite the efforts, the share price never recovered, dropping to $0.74 on the CSE before it was cease traded, down from a high of $4.25. Wayland's stock continues to trade over-the-counter in the U.S., where it closed at US$0.20 on Friday.

THE GLOBE AND MAIL

Cannabis company Tilt forced to amend financial filings after half-billion-dollar writedown

Tim Kiladze
July 31, 2019

Cannabis company Tilt Holdings Inc. has amended two major financial filings under orders from British Columbia's securities watchdog, disclosing more about its recent US$496-million writedown and removing language the regulator deemed promotional, among other changes.

The refiling is the latest development in a three-month saga that has seen the company blame its auditor for the writedown, replace its CEO, and pay executives and board members US$60-million after disclosing the writedown.

Tilt said the amendments were made after a "continuous disclosure review" by the British Columbia Securities Commission. In an e-mail, the BCSC said it typically does not disclose the reasons for such reviews, but added that "statements in the media from the company's former CEO formed part of our review but were not the sole reason."

The review also came after a US$119-million financing by Tilt in November that was underwritten by Canadian investment banks and led by Canaccord Genuity. The private placement was priced at $5.25 per share, and the stock closed at 85 cents Wednesday on the Canadian Securities Exchange.

Massachusetts-based Tilt is one of many companies marketed to Canadian investors as a means of capitalizing on the potential of cannabis use being legalized in the United States. With multiple divisions, Tilt offers cannabis production, retail software for dispensaries and consulting services.

As of Wednesday, Tilt has updated its "management's discussion and analysis," or MD&A, documents for two separate time periods: fiscal 2018, and the first quarter of fiscal 2019. Chief among the changes is a detailed explanation of the company's recent writedown, which was announced in May when Tilt reported its results for fiscal 2018.

In the original MD&A, Tilt said the non-cash charge was tied to its reverse takeover of Canada's Santé Veritas Holdings Inc. in November. As part of this deal, Tilt also acquired three other U.S. businesses – Baker Technologies LLC, Briteside Holdings LLC and Sea Hunter Therapeutics LLC – and merged them.

In May, Tilt recorded impairment charges on three of these businesses: US$132-million for Santé Veritas Holdings Inc., US$158-million for Baker Technologies and US$206-million for Briteside Holdings.

At the time, Tilt said the combined writedown reflects the “outlook on the medical cannabis industry in Canada as a result of the legalized recreational market." Tilt has been hoping to obtain a licence from Health Canada to cultivate cannabis for the recreational market, but there is no assurance it will succeed.

Twelve days later, Tilt’s former CEO Alex Coleman told The Globe “the statement about Canada and the medicinal market that was in our [financial statements] was inaccurate." He added that the assessment came from Tilt’s auditor, MNP LLP, adding that the auditor is “underresourced." Mr. Coleman is no longer with the company.

Tilt now attributes the writedown to overpaying for the acquired companies. In the amending filings, the company said its purchase prices were based on potential synergies and a positive long-term perspective for the industry. However, these inputs do not appear “in the quantifiable measurement process of the cash flows” for each division.

Tilt also said some of the variables involved in calculating the purchase prices were “descriptive, subjective or difficult to measure.”

The MD&A documents have also been amended to remove language deemed “promotional” by the BCSC; to identify the people involved in the company’s “related party transactions;” and to disclose more about the “significant increase” in consulting fees, general and office expenses, professional expenses and wages and benefits in fiscal 2018.

In an e-mail to The Globe, Tilt said the amendments were made to “address comments received [from the BCSC] and in order to improve the company’s disclosure."

THE GLOBE AND MAIL

The data game: How information on everything from flight patterns to parking lots can reveal valuable clues about where the market is heading; Sophisticated investors are paying handsomely to access alternative data from companies such as Quandl, searching for signs of deals and trends that will give them an investing edge

Tim Shufelt
20 April 2019

Last summer, a corporate jet owned by Encana Corp. embarked on a strange pattern of flights.

Over the course of a couple of months, the Calgary company's aircraft was tracked landing close to oil fields in Oklahoma, Utah and Montana. Encana had operations in none of those places. Houston-based Newfield Exploration Co., however, owned assets in all three locations. And it turns out that Newfield's jet was also on the move around the same time. Its executives seemed to take a particular interest in flying to Denver, which happens to be home to Encana's chief executive officer, Doug Suttles.

The mutual visits hinted that something was in the works. And in early November, Encana struck the largest deal in its history when it agreed to buy Newfield for US$5.5-billion. An aggressive expansion into U.S. shale represented a dramatic change of course for the Canadian driller, and the deal caught the market by surprise. When trading started the next morning, Encana's stock plummeted by 17 per cent. A select group of investors, however, may not have been quite so shocked. They had access to the movements of Encana's jet, giving them strong clues about what the company's executives were up to in the months before the acquisition.

Quandl Inc., a Toronto-based startup, allows investors to peek in on the travel habits of companies such as Encana. By stitching together data from aircraft registries, corporate filings and flight communications, Quandl can track the movements of thousands of corporate jets around the world, giving investors a new advance signal of potential market-moving corporate deals.

Known as "alternative data," this kind of insight into publicly traded companies is proliferating, as investors and fund managers look to data science for an edge that will help them beat the market. Jet activity can foreshadow corporate deals; aggregated credit-card tallies can reveal consumer trends; satellite imaging can track oil inventories; information "scraped" from job sites can indicate who's hiring; data collected by auto insurers can give clues on future car-sales figures. The vast pools of information being generated by the digital economy hold the power to better predict what companies will do and how their stocks will perform.

The computer sophistication and machine learning needed to make sense of all that information, meanwhile, is quickly evolving. Until recently the purview of quantitative hedge funds, alternative data methods are spreading to mainstream investing. In December, Quandl was acquired by Nasdaq Inc., which runs a data products business in addition to operating stock exchanges. The deal amounted to an "inflection point for the industry," wrote Richard Johnson, a vice-president in Greenwich Associates' market structure and technology group. Competition among data providers is heating up. In February, Bloomberg launched a site featuring 20 alternative data sets.
"The race to take alternative data mainstream has now begun in earnest," Mr. Johnson said.

It's a race that Canadian investors have been reluctant to join. Despite its Toronto address, Quandl has zero Canadian names on the list of major clients subscribing to its 50-odd data products, which range from estimates of Tesla sales to industrial-auction results. Outside of the big pension funds, in fact, it appears few Canadian investors are dabbling in alternative data.

There are reasons to be cautious. There is a growing discomfort over the capacity for Big Data analytics to observe the intimate details of people's lives. Meanwhile, the legalities over data collection and distribution can be murky, raising concerns over who owns particular information and who has the right to sell it. There are tough questions regulators are just starting to grapple with, including whether sophisticated investors gain an unfair advantage when they have access to data that is effectively unavailable to the masses.

And yet, wary Canadian investors run the risk of being left behind if they wait too long. Alternative data will soon be essential to generating competitive returns, says Tammer Kamel, Quandl's CEO. "It will become unacceptable to be basing your investment decisions on what happened a few months ago."

For decades, standard financial data has been the lifeblood of fundamental investing. Investors glean what they can from whatever public companies are required to disclose through regulatory filings and quarterly financial statements. A handful of data providers, including Bloomberg, Refinitiv and FactSet, have come to dominate the distribution of that information. (Refinitiv is partially owned by Thomson Reuters Corp., which is controlled by Woodbridge Co. Ltd., owner of The Globe and Mail.) In 2018 alone, investors spent in excess of US$30-billion globally for access to market data and analysis, according to an estimate by Burton-Taylor International Consulting.

Alternative data means anything considered to be outside the realm of traditional financial information, but that can yield valuable market or company insight. And it's by no means a newly invented category. Investors have long hunted for tradable information outside the bounds of financial reporting. It used to be said that the thickness of U.S. Federal Reserve chair Alan Greenspan's briefcase could portend monetary policy announcements. (A big haul meant he was carrying the documentation to support a rate cut, or so the theory went.) Hedge fund managers have also been known to directly observe retail foot traffic or cross-border shipping or executives appearing in certain airports – anything to get a read on what, or how well, a company is doing at that very moment.

What has changed is the sheer volume of data now being produced, everywhere. The internet has more than 1.5 billion live sites. Facebook users create about 3.3 million posts a minute. The Internet of Things is connecting everything from cars to household appliances, and smartphones are constantly trackers their users' locations. By next year, roughly 1.7 megabytes of data will be generated each second for every person in the world.

Most commercial information is simply "exhaust" – a byproduct of a company's main business, Mr. Kamel says. But there is an active market for those companies to turn their data into revenue. Many telecommunications companies give third parties access to user location data for a fee; financial intermediaries will compile credit-card transaction data; and policy information from auto insurers can reveal which models of cars are selling best. "You can find out almost anything you want to know about a stock or a commodity or a consumer, if you connect to the right database," Mr. Kamel says. "Somebody's taking that measurement."

That's where alternative data providers come in, typically licensing that information and turning it into data sets marketed to big hedge funds and asset managers. There are currently more than 400 providers like Quandl, up from around 100 a decade ago, according to alternativedata.org . "Web scraping," or data extracted from websites, is the largest subcategory. Using data scraped from Best Buy Co. Inc.'s website, for example, New York–based startup Thinknum showed robust sales in Amazon products, such as its Alexa-powered smart speakers, starting around Black Friday last year – nearly one month before Amazon.com Inc. announced record holiday sales for its devices. Research firm Opimas estimates that hedge funds and asset managers scraping sites for investment purposes accounted for 5 per cent of all web traffic last year.

So-called sentiment data scraped from social media, financial news and online forums are among the more established alt data products. Toronto-based Buzz Indexes built a model that scours sites like StockTwits and Twitter for insight into how investors feel about individual stocks. A natural language processing algorithm looks for signs of investor positivity toward U.S. large-cap stocks and calculates a sentiment score for each name. The 75 stocks with the highest scores are included in the Buzz NextGen AI US Sentiment Leaders Index, which, back-tested to the start of 2013, has returned an average of 17 per cent annually, compared to 11 per cent for the S&P 500 index. Not too long ago, the idea that there might be wisdom in the online conversations of investors was met with cynicism, says Buzz Indexes founder Jamie Wise. "Today, there's probably not a CIO at any major asset manager on the continent that isn't thinking about an alt data strategy."

Many have progressed well beyond the thinking stage. BlackRock uses an active quantitative approach in its Advantage funds, which search for investment signals from a range of data sources, including weather patterns, travel-site bookings and employee reviews from sites like Glassdoor.com . "Combining millions of responses can indicate a company's state of health, as those with happy employees tend to outperform their competitors," BlackRock said in a recent brochure for its Advantage funds. Meanwhile, Franklin Templeton Investments recently signed a deal with platform company Elsen, giving traditional portfolio managers easier access to big sets of data.

For large investors and asset managers, getting access to market and company intelligence that gets as close as possible to real-time data is worth paying good money for. Quandl's datasets range in price from US$25,000 to US$250,000 a year. Other products on the market, like specialized satellite intelligence, can cost upwards of US$1-million a year.

A pair of professors from the University of California at Berkeley recently demonstrated how satellite images' predictive power can justify such an extravagant price tag. They looked at daily images of the parking lots of major U.S. retailers, including Walmart and Target, over a six-year period to identify whether counting car traffic could help predict earnings and stock movements. A trading strategy built on buying shares in retailers with abnormally high parking lot traffic, and shorting those with low traffic, would have paid off handsomely once earnings were announced, the analysis found. Compared to a buy-and-hold approach, that satellite-informed portfolio generated average excess returns of 4.6 per cent.

Silicon Valley-based Orbital Insight is one of the leaders in using satellite technology to spot tradable economic or company data in real time, mostly in the consumer and energy sectors. Last September, RBC Capital Markets announced a partnership with Orbital that provides the investment bank with geospatial data to include in its equity research. An RBC report from January said Orbital's images of storage tanks pointed to declining global crude oil inventories from their December peak – one sign the market could be tightening and prices headed higher.

"Everybody's trying to get into the alternative data space," says Fardeen Khan, head of strategic initiatives at RBC Capital Markets. But he adds that it's not a standalone investment approach. The idea behind RBC's arrangement with Orbital, as well as the bank's other data science endeavours, is to complement the fundamental and technical process. "When you look at alternative data as a standalone, the insights are not sufficient to say you should go fully long on this company or go short on a specific name," says Mr. Khan.

That sentiment is echoed by Ron Mock, CEO of Ontario Teachers' Pension Plan, which uses some data-driven trading strategies and is "leveraging the deep insights it's capable of bringing," he said during a discussion at the World Economic Forum in Davos, Switzerland, in January. "We have to be very, very mindful, that we can't push it so far that we turn our brains off."

Nearly a decade ago, hedge funds were the only ones most willing to take a chance such an exotic, untested idea as using alternative data, and they have been the main driver behind the growth of that industry. Global spending on alternative datasets is currently about US$3-billion per year, according to JP Morgan, a small fraction of the size of the conventional data business.

For the industry to assume a larger profile, it will need to extend its appeal to more traditional asset managers. Now is a good time to do just that, Greenwich's Mr. Johnson says. "A lot of active managers are struggling to beat passive benchmarks, and they're looking for a new edge," he says. The passive investing craze has made life difficult for traditional active managers. Franklin Templeton, for example, saw its global assets under management decline by 14 per cent last year.

The average active fund manager, however, has very different data needs than a giant U.S. quant fund. Without the infrastructure to analyze raw data, most fundamental investors require data that have been ingested, formatted and packaged, or fed into platforms they can incorporate into their own investment processes. Quandl's corporate-jet-tracking app is one example of this.

The idea for an aviation-based investment tool came out of a hedge-fund trade from early 2017. A trio of New York-based funds figured out how to track Johnson & Johnson's Gulfstream jet on the internet and found it sitting on the tarmac at a Swiss airport for more than a week, just a few kilometres away from the headquarters of pharmaceutical company Actelion Ltd. Convinced a major tie-up was being negotiated, the hedge funds loaded up on Actelion shares, which soared when J&J announced a US$30-billion deal to acquire the Swiss company a few days later. When Abraham Thomas, Quandl's chief data officer, read about that payday, he thought: "What if we could automate that process?"

By combining flight location data and ownership information from several different sources, Quandl can now track the flight activity for a majority of the companies in the Russell 1000 Index. Most of those companies, however, would prefer to keep that information to themselves. They'll often try to conceal their own aircraft through subsidiaries and holding companies, or complex leasing arrangements. By poring over aircraft registrations, operator licences, public filings and corporate parent-subsidiary relationships, Quandl has built a database of 29,000 jets and counting.

Most subscribers are using the product as one part of an M&A investing strategy, to help shed light on rumours or suspected deals, Mr. Thomas says. Others use it for protecting their short positions. Investors betting against a stock are vulnerable to that company being acquired, since such an announcement typically results in a big jump in share price – and big losses for short sellers. “On other occasions, activist hedge funds want to find out if the CEO is gallivanting around the world on the company dime,” Mr. Thomas says.

Corporate jet data is one of dozens of data sets that Quandl says puts it in the alternative-data lead, Mr. Kamel says. Already, the company leads the industry in brand recognition, according to a recent Greenwich Associates study. And being acquired by Nasdaq represents a huge boost to the company’s profile and credibility. “When you hand someone a card that says Nasdaq – part of the fundamental structure of capital markets – that helps a lot,” Mr. Kamel says. “Now we’re standing on the shoulders of a giant.”

So far, Canadian hedge funds have taken a pass on alternative data – almost all of them, in fact, according to Claire Van Wyk-Allan, head of the Canadian chapter of the Alternative Investment Management Association. Most Canadian players are just not big enough to justify the cost. The hedge fund industry here pales in comparison to behemoths on the other side of the border. Bridgewater Associates, for example, manages about US$160-billion, while only a handful of Canadian hedge funds surpass even the US$1-billion mark.

“We are not able to spend $100,000 every month on all kinds of data. We aren’t Bridgewater,” says Ernest Chan, who runs QTS Capital Management in Niagara-on-the-Lake, Ontario, and manages a small hedge fund. His own experience with alternative data suggests it generates one to two percentage points of “alpha,” or excess returns. For Bridgewater, that would amount to a boost to annual returns of US$1.6-billion to US$3.2-billion. “But if you are $100-million fund, alternative data is not must necessarily a must-have,” Mr. Chan says.

The major Canadian pension funds, on the other hand, are certainly big enough to use algorithmic trading strategies and advanced data analytics. “If you go to a quantitative investment conference, it is dominated by pension plans,” Mr. Chan says. Canada Pension Plan Investment Board, Ontario Teachers’ Pension Plan and Alberta Investment Management Corp. all declined to comment on how they’re using alternative data in their investment decisions.

Canada’s big asset managers, meanwhile, appear to be on the sidelines when it comes to alternative data. While Quandl boasts of having 14 of the world’s 15 largest asset managers as customers, the company has yet to land a big Canadian name. “It's a little frustrating that it's easier for me to sell in New York than in my own backyard,” Mr. Kamel says. Though Toronto has emerged as a global fintech hub, Bay Street asset managers seem reluctant to evolve. “Canadians just might be used to doing things the regular old way,” Ms. Van Wyk-Allan says.

Part of the hold-up might be in how alternative data is typically marketed. “Looking at this data as a source of alpha is like entering into a nuclear arms race, where you’re constantly in search of the next data set,” says Ashby Monk, executive director of Stanford University’s Global Projects Center, which studies, among other things, how technology can improve long-term investing. “If you’re a patient investor, that’s probably not the best use case for alternative data." Instead, he suggests it can be used to better understand risk in a portfolio, to assist in due diligence and to make better capital allocation decisions.

Alternative data is by no means risk-free, however. It’s an unregulated space that lacks legal clarity. While insider trading generally has a fairly narrow legal definition, some alternative data strategies are starting to look awfully similar. The common regulatory test for insider trading asks whether a piece of information is material and non-public. Alternative data certainly has the power to be material to a company’s stock, by providing timely indicators of a company’s health. And if distributed only to a limited number of investors, or even exclusively to a single hedge fund, it can be difficult to argue that data is public.

“The line between public and material non-public information is key here,” says Kirsten Thompson, a partner at Dentons and national lead of the law firm’s transformative technologies and data strategy group. “Securities regulation requires you to know which side of that line you are on, and alternative data makes that difficult.” Some large hedge funds are known to avoid buying “exclusive” datasets for fear of legal risk.

There is growing alarm, meanwhile, around the sharing of personal data by companies that compile it. Last year, it was discovered that location information on U.S. cellphone users sold by telecom providers was ending up in the hands of bounty hunters. Canadian telcos also sell location data to third parties, which they say is only done with users’ explicit consent.

Canadian privacy legislation regulates the personal information that corporations collect, limiting the ways it can be shared. And in any case, investors are not interested in obtaining anyone's personally identifiable information, Quandl's Mr. Thomas says. "We tell our vendors, if you have personal records, don't even send us the data. We don't even want it to touch our servers."

But it can be difficult to truly anonymize certain information. "Our machine learning and our algorithms are now getting so sophisticated that you may have data that you think is not identifiable, but the algorithm can, in fact, identify somebody," Ms. Thompson says. Data science can also be used to approximate protected data. Access to Canadian credit scores is limited, for example, but a fairly accurate estimate can be computed from other sources, including social media.

Investors considering accessing alternative data need to conduct their due diligence, Ms. Thompson says. "There's a constellation of questions you should be asking, including the sources of data, appropriate consents, the genesis of the information." Data harvesting methods like web scraping can violate the terms and conditions set out on a website's fine print, in which case, data vendors would be prevented from selling that information.

Quandl says it is offered about 100 data sets each month by companies and data hunters looking to cash in on the data they have collected. In addition to evaluating the data quality and its potential value to investors, the company says it takes pains to trace each potential data set back to its original source. "Our customers understand we've vetted the data for personal information, insider information and ownership issues," Mr. Thomas says.

Outside of Canada, adoption of alternative data is growing fast, despite the regulatory limbo. Canadian investors won't have the luxury of taking a cautious approach much longer, Mr. Thomas says. "As it spreads wider and wider, if I don't have this data, I'm at a disadvantage. It becomes table stakes."

THE GLOBE AND MAIL

'Investors continue to be abused': Anger builds over lack of reforms to early-withdrawal fees on mutual funds

Ontario plans 'no change in direction' in opposing a ban

Clare O'Hara
Wednesday, July 24, 2019

Investor advocates are expressing frustration that fund companies are still able to charge early-withdrawal fees on mutual funds, nearly a year after securities regulators concluded they should be banned.

The renewed calls for action come after fines were levied against certain advisers who improperly sold the products to senior citizens who had no idea they were subject to the fees.

"It's preposterous how long this process is taking," said John De Goey, a portfolio manager with Wellington-Altus Private Wealth.

Last fall, after a six-year review, provincial securities regulators proposed a prohibition on what are known as deferred sales charges (DSCs), a fee investors must pay when they pull money from their mutual fund before a set date. Shortly after, the Ontario government released a statement opposing the ban on DSC funds.

"The proposed amendments result from a process initiated under the previous government and, if implemented, will discontinue a payment option for purchasing mutual funds that has enabled Ontario families and investors to save towards retirement and other financial goals," the statement said. "Our government does not agree with this proposal as currently drafted."

The Progressive Conservative government never elaborated exactly how the new proposals would hinder such efforts to save. But its opposition stalled the planned reforms, and immediately raised the possibility that no changes would take place.

During a cabinet reshuffle last month, Ontario's new Finance Minister Rod Phillips said in a media interview the government will continue to focus on priorities detailed in its budget but will "correct mistakes" when it makes them.

Investor advocates were hoping the announcement made last September by his predecessor Vic Fedeli – that essentially killed the regulatory reforms – would be one of those "mistakes."

But Scott Blodgett, a spokesperson for the Ministry of Finance, recently told The Globe and Mail there has been "no change in direction" when it comes to the government's stance in opposing the mutual fund proposals.

"We continue to work with other provinces and territories and stakeholders to ensure fair, efficient capital markets and strong investor protections," Mr. Blodgett said in an e-mail.

Doug Walker, senior policy counsel at FAIR Canada, an advocacy group for shareholders rights, expressed disappointment that the new minister is standing by the government's position to oppose the proposals, which were issued by the Canadian Securities Administrators (CSA), an umbrella group for all provincial securities regulators.

"The government had previously said last September it was going to propose alternatives but there's been no indication what that means in terms of these needed reforms and what the government's time frame is. In the meanwhile, investors continue to be abused by these deferred service charges."

"Any further delay is a slap in the face to individual investors," Mr. Walker said.

Regulators are still deciding what the next step will be when it comes to selling DSC funds.

Despite the Ontario government's opposition last fall, the CSA continued the 90-day comment period right through to its conclusion in December. The Ontario Securities Commission (OSC) is still in the process of reviewing the comments received, said a spokesperson.

In the meantime, the misuse of DSC funds continues to emerge. Earlier this month, Philip Winer, a former investment adviser in Ontario, received a $15,000 fine – and was asked to return $2,000 in commissions – for improperly selling DSC funds to clients in 2012 and 2016. Some of those clients were senior citizens without long investment time horizons.

Known as "sandwich trading," Mr. Winer – who was employed with Burgeonvest Bick Securities Ltd. at the time – sold DSC funds in his clients' accounts, and then a short time later used those proceeds to buy and sell equities. Within a short time frame, he would then move the money into new DSC mutual funds for the client, triggering new commissions for himself. In several cases, clients were charged redemption penalties.

"Most of these enforcement actions are overwhelmingly against individuals and many of the cases [we see] are similar to this," said Ken Kivenko, a prominent investor-rights advocate who assists victims of financial crimes. "But where was the supervisor on this? How do so many bad things happen, for so long, with no one within the firm noticing?"

Burgeonvest was bought by Industrial Alliance Securities Inc. in 2016.

Last May, the Mutual Fund Dealers Association (MFDA), which oversees mutual fund firms and financial advisers, held Investors Group Financial Services Inc. accountable for an adviser's improper use of DSC funds in 2013 and 2014.

Investors Group paid a $150,000 fine and $15,000 in costs to settle allegations that it violated MFDA rules by failing to adequately supervise the suitability of two clients, both of whom were more than 90 years old, being sold DSC funds with seven-year redemption schedules.

“Regulators did not go far enough in the proposals and ban all types of commissions for mutual funds, but they at least moved in the right direction with [the proposal to ban] DSCs,” Mr. De Goey said.

“Unfortunately, we have one provincial government that is taking a step backward.”

For the coming year, both the CSA and the OSC have included the proposed rule changes for embedded commissions on their priority lists. The CSA says it will look at solutions to “mitigate the conflict of interest and related investor harms arising from the use of the DSC purchase option.”

Follow this link to view this story on globeandmail.com: **‘Investors continue to be abused’: Anger builds over lack of reforms to early-withdrawal fees on mutual funds** The viewing of this article is only available to Globe Unlimited subscribers.

THE GLOBE AND MAIL

Ontario alone in opposing ban on early withdrawal fees for mutual funds

CLARE O'HARA
December 20, 2019

Canada's provincial and territorial securities regulators are set to ban two controversial types of mutual-fund fees, but Ontario has opted not to adopt one of the key reforms that will outlaw charging investors early-withdrawal fees.

Last fall - after a six-year review - the Canadian Securities Administrators (CSA), an umbrella group for all provincial securities regulators, proposed a prohibition on what are known as deferred sales charges (DSCs).

The fees are charged to investors when they pull money out of a mutual fund before a set date. The adviser who sells the fund receives an upfront commission that is often higher than commissions for other types of mutual funds. Regulators have argued it is not appropriate that advisers have an incentive to recommend DSC funds over more flexible funds with lower costs.

Regulators also proposed banning some advisory fees charged to do-it-yourself investors who buy mutual funds through discount brokerages where they receive no advice.

On the same day that regulators opened a comment period on the proposals last year, the Ontario government released a statement opposing the ban on DSC funds.

Then-Ontario finance minister Vic Fedeli provided almost no explanation for the opposition, stating only that it would work with other provinces and territories to "explore other potential alternatives."

Now, without the approval of the provincial government, the Ontario Securities Commission will have to step aside as the rest of Canada's provincial regulators move ahead on banning DSC funds.

At the same time, the CSA announced Thursday that all provincial securities commissions - including Ontario - will proceed with plans to ban mutual-fund trailing commissions paid to investment dealers who do not make recommendations to clients - such as discount brokerages.

Both bans will have a transition period of at least two years, the CSA said.

Dan Hallett, vice-president and principal with HighView Financial Group, has advocated against the sale of DSC funds for decades, arguing the structure was only created to preserve generous commissions for mutual-fund sales.

He said Ontario's decision to go its own way and expect other provinces to follow was an "arrogant" approach.

"The statement says that the rest of the country is wrong and Ontario knows better; and that they'll meet with others to make them see the light. I applaud other CSA members for moving forward with the right decision."

DSCs force clients to pay as much as 6 per cent to cash out their mutual funds, a fee that tends to fall by one percentage point each year, down to 0 per cent after investing for five to seven years.

While only 10 per cent of all mutual-fund assets in Canada carried the DSC option at the end of 2018, it still accounted for more than $155-billion of investor money sitting in the funds.

The CSA said participating provinces plan to publish final amendments for adoption in early 2020.

"The ban on upfront sales commissions from investment funds to dealers will eliminate an incentive for dealers to recommend investment products that provide them with an upfront commission from the fund company, instead of recommending other suitable investments that have lower costs and do not have redemption fees," the CSA said in a statement.

The Ontario Securities Commission - in a separate notice on Thursday - said it is considering other ways to restrict the use of DSC funds to "mitigate negative investor outcomes."

Such restrictions may include: banning sales to seniors; shortening the length of time to hold a fund while incurring withdrawal penalties; banning the use of borrowing funds to purchase an investment; putting limits on account size; and offering investors a "hardship exception" to avoid a withdrawal penalty.

"We want opportunities to be available for all types of investors, while balancing the need to ensure investors are protected and are using products that are right for them," Emily Hogeveen, a spokeswoman for the Ontario Ministry of Finance, told The Globe and Mail.

"That is why we are not moving forward with this ban, but will be considering options to strengthen investor protections surrounding the use of deferred sales charges."

In the coming months, Ontario will work with the CSA to finalize the ban on trailer fees at discount brokerages.

Of the total $30-billion in assets held in mutual-fund products in discount brokerages across Canada, more than $25-billion remain in fund series that bundle an advice fee within the product, according to a CSA paper released in 2017.

The controversial payment, which has already charged DIY investors millions of dollars in fees for advice they do not receive, has sparked several class-action lawsuits filed against some of Canada's largest asset-management companies. The first class-action certification motion - against TD Asset Management - will be heard in court on Jan. 10.

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Phillip Crawley, Publisher

THE GLOBE AND MAIL

Judge clears class action to proceed against TD over fees charged on mutual fund sales

CLARE O'HARA
February 28, 2020

An Ontario court has green-lit the first in a series of class-action lawsuits against the investment arms of Canadian banks in a dispute over millions of dollars in commissions paid by do-it-yourself investors for advice they did not receive.

Ontario Superior Court Justice Edward Belobaba has certified a class-action lawsuit against TD Asset Management Inc. regarding trailing commissions paid to discount brokers on some TD mutual funds.

Trailing commissions are typically used to compensate an individual or firm for advice and services provided to an investor.

But do-it-yourself investors using discount brokerages usually do not work with advisers to purchase investment products, and do not receive advice.

The certification ruling is key because the class action is the first of seven filed by Siskinds LLP and Bates Barristers P.C. against the mutual fund arms of all six of the major banks, as well as Mackenzie Financial Corp.

Paul Bates, co-counsel for the plaintiff, said Thursday he was not surprised by the decision, and anticipates the remaining six cases to "quickly be determined on the basis of the TD decision" and be certified by the courts.

The proposed action claimed damages of $200-million and other relief on behalf of TD investors who hold or held such TD funds at a discount brokerage. That amount may be updated in later filings, Mr. Bates said.

The TD class action was filed in April, 2018, on behalf of plaintiff Gary Stenzler, a retired dentist who had purchased TD mutual funds as a do-it-yourself investor using an online brokerage account but was charged trailing fees for advice he never received.

TD declined to comment on the case, stating that "as a policy we do not comment on matters that are before the courts."

The controversy over advice fees being charged to DIY investors came to light several years ago after regulators were called in to take a closer look at Series A mutual funds that were being sold through discount brokerages.

Series A are typically sold through a financial adviser and include trailing commissions for the advice an adviser provides.

Series A funds account for 68 per cent of the total amount of mutual funds assets in Canada, according to the Investment Funds Institute of Canada, and can charge a management expense ratio (MER) between 1.5 per cent to 2.5 per cent. By comparison, Series D funds that are tailored for do-it-yourself investors and strip out advice fees can have an MER of less than 1 per cent.

Regulators are currently in the process of banning the practice of discount brokerages charging such fees after the Canadian Securities Administrators, an umbrella group for all provincial securities commissions, announced there was "no justifiable rationale" for paying discount brokers any continuing commissions for the sale of a mutual fund.

But the investors who have been paying millions of dollars in fees for years are now seeking reimbursement for the charges that Mr. Stenzler says "depleted" the assets of his TD funds, which in turn "reduced the value" of his investments and thus the overall return on this investment.

Mr. Stenzler isn't pointing the finger at the discount brokerage as the one responsible for overcharging him in investment fees, but rather the investment-fund manager that created the mutual funds and paid the fees to the discount brokerage.

(A separate group of Canadian investors have filed a proposed class-action lawsuit against the discount brokerage companies, which has not yet been certified.)

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Phillip Crawley, Publisher

An overarching financial cycle is spawning corporate zombies

Firms caught up in the cycle do not have enough profits to cover interest payments on their debt

Yan Barcelo 19 March, 2019

An increasing number of economists and market participants fear the huge debt overhang – and the spawning of zombie companies – that monetary policies have produced in the last decade.

The prevalent view among academic economists focuses on the business cycle, to which the credit cycle is an appendix. "The credit cycle is just part of the business cycle," asserts Angelo Melino, professor of economics at the University of Toronto, reflecting mainstream views. "It is only one of many shocks that can happen to the business cycle."

At the C.D. Howe Institute, Associate Director Jeremy Kronick reflects a similar perspective when he says, "It's hard to evaluate the typical economic indicators. Yes, debt might be high, but then, cash flow or asset value could also be better. After all, the Bank of Canada has increased rates five times since July 2017, and markets have survived; there has been no debt collapse."

However, both specialists are not blind to the factors of interest rates, monetary policy and debt burdens. "I agree, there is a heightened sensitivity of economic actors to interest rate increases," recognizes Kronick, as does Melino when he adds, "Central banks have been major drivers of the business cycle in the last 40 years. But financial collapses are rare events. It's hard to know if things driving the business cycle have changed and could now be more linked to credit cycles."
Indeed. But studying the financial cycle specifically is the main focus of Claudio Berio, head of the Monetary and Economic Department at the Bank of International Settlements, in Basel, Switzerland. And he believes that the financial cycle is now driving the economic show – though he hasn't quite demonstrated it yet.

His work identifies two distinct cycles: the business cycle, typically lasting up to 8 years, and the financial cycle, typically spanning 16 years. Sometimes they differ, as in the somewhat short recession that followed the techno bubble burst of 2000, sometimes they overlap, as in the Great Recession of 2008, when the financial collapse exacerbated and prolonged the economic downturn. Today, the financial cycle, still in an expansion phase, is calling the shots.

Central to the financial cycle is monetary policy, which can help heal a recession, or prepare the next one. If it is too accommodating, as we have witnessed for the last 10 years, it exacerbates underlying weaknesses in a paradoxical way. In a 2013 paper, Berio wrote, "The basic reason for the limitations of monetary policy in a financial bust is not hard to find. Monetary policy typically operates by encouraging borrowing, boosting asset prices and risk-taking. But initial conditions already include too much debt, too-high asset prices (property) and too much risk-taking. There is an inevitable tension between how policy works and the direction the economy needs to take."

Why has the impact of the financial cycle grown in the economy since the early 1980s? Berio outlines three potential causes: financial market liberalisation since that time, inflation-focused monetary regimes, globalisation and the rise of China, that have muted inflationary pressures while still allowing financial booms to build up further without the check of monetary tightening to rein them in.

These theoretical considerations lead to very practical conditions. Before the 2008 crisis, there was an asset bubble in residential real estate, and household debt shot up to historical highs. Today, debt has shifted to the corporate landscape, now haunted by "zombie firms". Such firms, at least 10 years old, have insufficient profits to cover interest payments on their debt. "In 1987, the probability of a zombie firm remaining a zombie in the following year was approximately 40%; by 2016, it had risen to 65%," notes Berio, who believes that low interest rates incentivize firms to keep debt levels high.

The low cost of money has also prompted a spectacular rise in total corporate indebtedness, thinks Jean-Pierre Couture, chief economist and portfolio manager at Hexavest, in Montreal, adding that "interest rates don't need to increase a lot in order to bite into corporations". A tipping point appeared in the last quarter of 2018 but was quickly blotted out by pacifying central bank announcements. Rates increases can bite more viciously than ever, claims Couture, since corporate debt is at an all-time high in the U.S. as well as in Europe and China. In the U.S. alone, it has slowly risen from a share of 120% of GDP in 1970 to 280% in 2018. At the same time, the quality of that debt has alarmingly deteriorated: today, nearly 49% of investment grade companies are rated BBB, just a notch above junk status; in 2009, during the crisis, that proportion was 32%.

"A lot of that debt has fueled the phenomenal growth of share buybacks, a bad allocation of capital, that doesn't go into the productive engine and only serves to gratify shareholders," says Jean Charbonneau, senior vice-president and portfolio manager at AGF Investments, in Toronto.
All this tremendous amount of debt has been channeled through the also phenomenal rise of collateralized loan obligations (CLOs) that carve out a share of more than 80% in the US$850 billion U.S. collateralized debt obligations (CDOs) market, the financial derivatives products that became infamous during the 2008 crisis.

This CLO market is a big boy institutional game, without retail players, points out Couture. Little understood by mainstream media, this market, presently under the radar, will become the focus of attention when the next recession hits. We are just waiting for the moment when large investors lose their appetite for such instruments, says Couture, because "never before has the possibility to leverage so much depended on the appetite of investors who are fed these CLOs through banks." There was a time when officials simply let recessions play themselves out to purge the economy of all its putridity, indicates Couture. Now the real economy depends more than ever on the sensitivity of investors to the availability of credit. To characterise the whole situation, he uses an image that all snow-bound Canadians will understand: "We shovel the snow by piling it up ahead of us."

MORNINGSTAR

Invest in transportation disruption

New vehicle technologies and industries are coming faster than you think, and investors will want to get ahead of the major social and economic changes that follow

Yan Barcelo 5 September, 2019

Big changes are coming in the world of transportation that could take us from electric vehicles to autonomous electric vehicles and, ultimately, to a new norm of private transport as a service, eliminating car ownership altogether. These developments will usher in major social and economic changes, and present significant opportunities – and pitfalls – for investors.

"Our mental models about mobility – individually owned cars, gas stations, traffic jams, the driver's license as a rite of passage – are on the verge of disruption, states a recent McKinsey Quarterly article. Mobility is about to become cheaper, more convenient, a better experience, safer, and cleaner – not 50 or even 25 years from now, but perhaps within a dozen".

Everything is going electric

This disruption of the transportation industry hinges on the convergence of a number of technologies around batteries, electric vehicles, autonomous vehicles, ride-hailing, artificial intelligence, massive digital signal processing.

But the first game-changer is Electric vehicles (EV) and a drop in their prices. Still more expensive than traditional cars built around internal combustion engines (ICEs), EVs should become competitive and go mainstream by 2022, according to Nathaniel Bullard, BloombergNEF energy analyst. Wood Mackenzie thinks they could make up 85% of car sales by 2035.

The impetus behind EVs is battery capacity and prices. "For a midsize U.S. car in 2015, the battery made up more than 57 percent of the total cost. This year (2019), it's 33 percent. By 2025, the battery will be only 20 percent of total vehicle cost." By then, a buyer will prefer an EV over an ICE-powered car essentially for taste or style considerations, Bullard considers.

Tony Seba, partner at RethinkX, believes people will massively move to EVs for economic reasons. An ICE is only 17% to 21% efficient, houses 2000 moving parts, costs US$ 3,000 a year to refuel while giving you a total run of 200,000 miles. EVs are 90% to 95% efficient with only 20 moving parts and the yearly cost of recharging will on average amount to US$ 300 allowing you to run for 500,000 miles (up to 1,000,000 miles by 2030). Numbers like these, showing 10 times cheaper costs of refueling and maintenance and five times increased durability will further accelerate the adoption of EVs.

Ownership will change as you know it

The biggest game-changer, according to Seba, will be autonomous vehicles (which by then will be mostly autonomous EVs (or A-EVs)), especially when A-EVs combine with the ride-hailing business model to usher in the age of Transport as a Service (TaaS). "A-EVs will soon replace not just cars powered by gasoline, but the very concept of individually-owned cars itself," states Seba.

Again, the economic equation could prove irresistible and greatly accelerate the TaaS model faster than what most forecasters predict. Owning a car represents an average yearly cost of $10,000, which includes repair, maintenance, fuel, insurance and parking. Fleets of A-EVs, owned by Uber-like TaaS suppliers would constantly roam streets and roads, allowing riders to have a car at their door within minutes.

Relinquishing individual ownership of cars, American families could save on average US$ 5,600 a year, greatly increasing their commuting safety and freeing up hours of off-the-wheel time. In fact, transportation could become free, at least in some markets, where sponsors would gladly pay for your ride. Consider Microsoft taking the bill while you work onboard with Office applications.

The economic consequences of a dominant TaaS scenario are huge, according to Seba. On the positive side, the US economy alone would benefit from a boost of US$1 trillion in family disposable income and another US$1 trillion boost to productivity, a 90% decrease in finance and insurance costs, an 80% decrease in maintenance costs, and a 70% reduction in fuel costs. Furthermore, the number of passenger vehicles, because utilization time would increase from 4%, presently, up to 40%, would drop from 247 million down to 44 million. Also, claims Seba “huge potential revenue streams will arise from additional services offered by TaaS providers, potentially resulting in free transport”.

On the negative side, up to 5 million jobs could be lost while traditional car manufacturers suffer and oil slumps by 30%.

How you can invest
Backing up such a scenario, countless technology players will prosper, even if Seba’s TaaS prediction doesn’t come true. A March 2019 study by McKinsey identifies ten key sectors that are piling up investments from many horizons, for example autonomous-vehicle sensors and driver-assistance systems and components, AV software and mapping, batteries, connectivity/infotainment, EVs, E-hailing, human-machine interfaces and computing services.

“Since 2010, investors have poured $US 220 billion into more than 1,100 companies across ten technology clusters, says the McKinsey report. (...) The industry invested US$120 billion in the last 24 months as it prepares for the years to come.” In these 10 technology clusters, investors can find star names like Tesla (TSLA), Uber (UBER) and Waymo, but also lesser known ones like LeddarTech, based in Québec City, a leading manufacturer of solid-state LiDAR (laser and radar) sensors destined for autonomous vehicles.

Industry players that investors should be attentive to are not only in hi-tech. While auto insurance companies get hit, some might profit, like Progressive (PGR) which already has a footprint in E-hailing as a commercial insurer for Uber and is developing a data-collection engine called *Snapshot*. Also, certain suppliers to players in the 10-industry cluster could be big winners. For example, battery makers, which have already built 35 megafactories, with 45 more on the way, will eventually need massive graphite supplies. That could favour graphite miners like Northern Graphite Corp (NGC) or graphite processing companies like NovoCarbon, both of which are Canadian companies. If the TaaS model comes on top, “the biggest opportunity and the key determinant of success will lie in monetizing the user base by creating entirely new revenue streams,” writes RethinkX, detailing entire industries yet to emerge. “In a competitive market, these profits will be largely passed on to passengers, opening up the possibility of free transport: advertising, entertainment, sponsorship, selling products and services, grid balancing, monetizing data, the unforeseen”.

The most attractive investment opportunities might just be those: the unforeseen.

Investing in a de-globalizing world

With a growing trend of protectionism, how should you structure your portfolio?

Yan Barcelo 25 November, 2019

Globalization has been an overarching economic and financial theme for 70 years. But now it's on hold, maybe even reversing.

"Winter is coming," warns CI Investments' global strategist Drummond Brodeur, who believes the world has entered a long-term trend toward protectionism and fencing off of national boundaries.

Since the end of World War II globalization has been on the rise and went into hyperdrive in the 1990s with the creation of the European Union single market and the euro, followed by the entry of China into the World Trade Organization in 2001. Combined with new technologies, globalization opened up significant opportunities, optimized supply chains, and prompted higher corporate profits and margins. "Deglobalization will work in the opposite direction," warns Brodeur.

The problem is political

Deglobalization has moved to centre stage thanks to a player that remained on the sidelines until now: politics.

"When I started Eurasia Group in 1998," recalls its founder Ian Bremmer, "the economic impact of political risk was largely contained to emerging markets. In developed economies and in the global economy as a whole, political developments only mattered at the margins. But now that we're experiencing an unwind of the U.S.-led global order, it's a different story. Today, geopolitics have become the principal driver of global economic uncertainty."

The U.S. is the main conductor of protectionism, but certainly not the only one. "There's rising populism: across EU countries and Brexit in Europe; with America First-led trade battles with just about everyone from Mexico, Canada and Europe to India; with rising tensions between Japan and South Korea," Brodeur explains.

Not a new phenomenon

Not all observers agree that deglobalization is the new black. David Tulk, portfolio manager on the Global Asset Allocation team at Fidelity Investments, recognizes that there is a move toward protectionism and observes that global trade has not progressed since 2012.

"I don't know if it really is a change in secular trend or just a cyclical adjustment, he says. I believe a longer trend continues toward globalization, though there can be pauses along the way."
Long-term trend or short-term hiccup, the present trade situation has introduced a new set of dynamics that investors have to contend with. A first dynamic is interest rates lowering again and reaching the negative return zone in many countries. Fearing the prospect of a global recession, central banks have pressed down once again on rates after trying for a few years to steer them toward higher levels.

The immediate result is a gain for investors already holding bonds. “Since the beginning of this year, total performance of bonds has been very positive in the 6%-7% range,” points out Alex Bellefleur, chief economist and strategist at Mackenzie Investments. However, going forward, the re-leveling of rates at historical lows spells nothing good for investors, believes Brodeur, who now have to deal not only with negative real interest rates, but also with negative nominal rates. “They represent an absolute transfer of wealth from savers to borrowers, he points out. Great for borrowers, very bad for savers.”

Inflation has not yet set in, notes Bellefleur. But that is only a question of time, believes Tulk. “Integration of supply chains helped to lower inflation, he says, but now their decoupling will cause higher costs and higher input prices that will ultimately impact consumer prices.”

R.I.P. modern portfolio theory
Rising inflation and lower interest rates, thinks Brodeur, should prompt investors to rethink a key notion of modern portfolio theory that built portfolios around the two basic asset categories of equities (considered high-risk) and bonds (viewed as low-risk).

That worked great when bonds still delivered 2%-4% real returns. But now they yield a negative rate in the vicinity of -0.5%. Such an investment “is risk-free only in the sense that there is almost no risk of an investor making any money after inflation,” Brodeur jokes.

Tulk agrees. “Inflation is a negative for equities as well as for bonds, he says. Investors are impacted on both sides. They have no place to hide.”

Real assets and diversification are key
Maybe investors can’t hide, but they can take refuge in cash-flow generating assets, advises Brodeur. The classic example is the Italian immigrant who puts his savings in rent producing property. These immigrants “focused on the cash flow of their savings, not on the short-term volatility of the balance sheet,” he points out.

Investors who can’t buy apartment buildings should lower their exposure to government bonds that pay 0-2% and increase it in “real assets” that stand outside the conventional definitions of the two dominant asset classes of bonds and equities: REITs, infrastructure, agriculture, etc.

On the equity side, investors should avoid the reflex of “circling the wagons” and staying home, agree the three commentators we spoke to. Up to the end of 2018, the U.S. carried the day, “but we don’t think they will keep it up, says Bellefleur. One should increase the international share of one’s portfolio.”

David Tulk does not exclude the U.S. as a destination, but only because he favours economies that have a greater capacity for self-sufficiency in a world where trade will become more challenging. That includes the United States, but also China, Brazil and a few other emerging market economies. Brodeur extends the vista for investors even more. They should be especially attentive to how China will develop its own separate sphere of influence, its own technologies, its own markets across Asia and Africa, independently from the United States.

Major winners will emerge and investors in their stocks will reap the benefits. But that means opening up one’s analysis beyond North America and Europe. “You will need to be more plugged into these geographies and need to identify who can play, who can’t, proposes Brodeur. Things will become more complex.”

FINANCIAL POST

The inconvenient truth about responsible investing
Victor Ferreira
November 25, 2019

The rise of responsible investing has been one of the biggest trends to emerge in the financial world over the past half decade, with hundreds of funds now bearing the ESG imprint, signalling that they incorporate environmental, social and governance principles into their investing processes.

According to the Responsible Investment Association, a Canadian industry-funded organization that champions the cause, responsible investing has swept up more than $2.13 trillion in AUM in Canada alone and now covers more than fifty per cent of the total assets that are professionally managed here.

But for investors hoping to see their ethical beliefs — especially when it comes to the environment and climate change — reflected in their portfolios, the contents of a responsible investing fund can come as a shock.

A Financial Post analysis of the 122 active responsible investing funds listed on the RIA's website found that 45 per cent still had exposure to at least one stock that is primarily engaged in the production, processing or direct transport of fossil fuels. That number is likely conservative because more than 50 of the funds on the list, which includes ETFs, mutual funds, pooled funds, GICs, segregated funds and private funds, only disclosed their top holdings, which made up as little as seven per cent of a portfolio. An additional 18 do not disclose any information about their funds at all.

The holdings the Post was able to access reveal that several funds are invested in stocks such as Enbridge Inc. and Cenovus Energy Inc. in Canada and Exxon Mobil Corp. and BP Plc outside of it. Many are also invested in a host of mining and utilities companies, both of which are heavily reliant on fossil fuels. Tobacco and alcohol stocks also found their way into some products on the RIA's list, which includes most of the responsible investing funds available in Canada.

In some cases, the funds containing fossil fuels made no specific claims about their fossil fuel holdings and only exclude sectors such as tobacco or gambling. In other cases, the apparent disconnects were more blatant, with the funds advertising themselves as “low CO2” or bearing the initials “ESG.”

"I would consider it greenwashing — they try to get that halo of responsible investing without doing the work," said Tim Nash, the founder of financial planning firm Good Investing, of those who play both sides of the fence.

Up until earlier this month, many of these funds were also represented inaccurately on the website of the RIA, which describes itself as non-profit educator and advocate for responsible investing in Canada. For each fund, the RIA lists the "negative screens" that apply — meaning those sectors that are entirely eliminated from the portfolio, information an investor might only be able to track down by digging through several hundred pages in a prospectus.

An entire suite of Desjardins ETFs were represented as having negatively screened for fossil fuels, nuclear energy, conflict zones and oppressive regimes when each of the seven funds carried multiple examples of these companies. The Post also found the website indicated funds from AGF, Russell Investments and CIBC Wood Gundy screened for fossil fuels when they each had oil and gas stocks in their portfolios.

When contacted by the Post, RIA CEO Dustyn Lanz said he was unaware the funds were mislabelled online and quickly had their descriptions altered. Lanz said in an email that the faulty information was a result of "data entry errors."

To be listed on the RIA's website, organizations need to sign up for membership and pay yearly fees ranging from $1,000 to $20,000. Their products must be marketed as responsible investing funds and each firm needs to disclose the details of their strategy in investment documents.

Desjardins and other fund providers told the Post they were the ones who were responsible for checking off the information about how to represent their funds in an application to be listed on the RIA's website.

Lanz was adamant that the RIA is not a regulator in the space. It doesn't "certify or rate products," he said. Instead, the association's role is to "promote education and awareness about responsible investing."

After the Post's inquiry, however, multiple fund providers said the RIA contacted them because it was performing an audit and wanted to verify that the details listed online for each fund were accurate. Some emails went as far as asking fund providers to point to where their prospectuses say they screen for a certain sector.

"I think it's absolutely essential that responsible investment funds are doing what they say they're doing," Lanz said.

"There is no place for misleading investors in our industry. Those that fail to live up to their claims will rightly be punished by the market."

How these funds wind up holding stocks that many investors assume they are shunning, appears to be partly a result of the evolution of the industry.

Responsible investing initially focused on eliminating controversial sectors — gambling, alcohol, cigarettes and weapons — to meet the ethical guidelines of faith-based investors who opposed them. As these funds began to appeal to both retail and institutional investors, the umbrella of responsible investing widened.

Currently, there is no one-size-fits-all definition of a responsible investing fund, nor is there an official body regulating the use of the term. If funds choose to use the designation, they must follow any guidelines they create for themselves in their prospectus documents. They make their own rules and can choose how strict they want their portfolios to be.

The RIA says there are multiple responsible investing strategies that firms can choose to implement, and that most funds incorporate more than one into their portfolios.

While negative screening remain a popular approach, the most widely adapted strategy, by far, involves so-called "ESG integration." To qualify, the RIA says, fund managers must use ESG data alongside traditional metrics when valuing companies, especially in the long-term. Notably, integration does not rule out investing in any particular sector of company. More than $1.9 trillion of the $2.13 trillion in AUM claims to follow ESG integration, some as their only strategy.

Positive screening involves investing only in a sector's best in-class names. Index providers such as MSCI rank companies based on their implementation of these principles and fund managers will build out a pool of the top stocks in each sector. This method does not result in exclusions by the sector, leaving fund managers open to owning the top 20th to 50th percentile of oil and gas stocks.

There are some funds that buy the same securities that a non-responsible investing fund would, and say they'll use their power as shareholders to pressure companies into adapting those principles.

A fourth type of fund focuses on thematic investing and is made up entirely of clean technology companies or those with women in leadership.

Should a fund use any one of these strategies, its AUM is counted by the RIA and lumped into the $2.13 trillion total for Canada. It's a gaudy number, but the mostly retail-oriented funds that disclose their assets and are listed on the advocate's website only account for about $24 billion of that total. The bulk of responsible investing assets are attributed to pension funds, such as the Canada Pension Plan Investment Board, whose approximately $400 billion in assets makes up about 20 per cent of the total.

The rapid growth of responsible investing is thus not primarily the result of investors pumping money into responsible investing funds; rather, as the RIA's 2018 report notes, "It is the result of large asset management firms implementing an ESG integration strategy across all of their assets."

For fund managers and index providers, many of whom stress that eliminating entire sectors can have a negative impact on returns, the breadth of responsible investing options provides plenty of wiggle room.

Twenty-one of the funds on the RIA's list do not perform any negative screens. One of them, the Ferique European Equity Fund, only discloses its top 25 holdings and had BP, Royal

Dutch Shell PLC, Portugal-based oil and gas company Galp Energia SGPS, S.A and British American Tobacco Plc within them.

"If you like everything in your portfolio, you're probably not diversified," said Jay Aizanman, a strategic advisor at Desjardins who helped put together the firm's suite of ESG ETFs. "Yes, you could theoretically eliminate sectors, but that might not necessarily do something for your performance long-term."

Most of Desjardins' ESG ETFs are described in their titles as being "Low CO2" but only negatively screen for tobacco and weapons stocks. As a result, investors will find names like Enbridge, Coal India Ltd. and Pembina Pipeline Corp. in the funds.

According to the Desjardins prospectuses of these ETFs, "carbon filtering" is conducted by removing the "most carbon intensive stocks." The firm is only seeking to reduce its carbon footprint by 25 per cent, Aizanman said, because a study it conducted revealed that returns would be impacted if Desjardins went any further.

In some cases, fund providers use strong, but vague language in their prospectuses against investing in certain sectors but don't expressly screen for them, meaning that some of the stocks are allowed to enter portfolios on technicalities.

Desjardins' fossil fuel reserves free ETF was represented on the RIA site as negatively screening for fossil fuels — but it only eliminates companies that have fossil fuel reserves. Because it doesn't own fossil fuel reserves but only processes them, AltaGas Ltd., is included in the portfolio without breaching the prospectus's guidelines.

Pembina remains a top holding in the CIBC Woody Gundy Blue Heron Income ESG Leader fund because the fund only screens for "integrated oil and oil, gas and coal exploration and/or production companies" and not those that transport fossil fuels, portfolio manager Graham Isenegger said.

Supermajor BP is still a part of the Russell Investments ESG Global Equity Pool despite a focus to tilt the "portfolio away from those companies with greatest exposure to carbon-related risk," according to its prospectus.

Russell Investments spokesperson Steve Claiborne defended the investment, arguing the firm's research shows "divesting entirely from fossil fuels can lead to lower exposures to renewable energy because many companies that hold fossil fuel reserves are also some of the largest investors in renewable technologies."

Even the country's largest pension plans have followed this strategy, championing commitments to responsible investing, which still allow them to actively purchase everything from oil and gas stocks to weapons manufacturers. Take the Canada Pension Plan Investment Board, as an example, which has US$685 million in Canadian Natural Resources Ltd. — it's 10th largest holding, according to its most recent disclosures to the

SEC — and has faced criticism as recently as September for owning assault rifle maker Ruger and Olin Corp.

The CPPIB's policy on responsible investing, which was written in 2010, sets the fund up to pursue two responsible investing techniques: It uses ESG integration in its investment decision-making process and flexes its power as a shareholder to pressure companies into adapting stronger policy.

Its mandate, however, is to maximize returns for beneficiaries.

"Investment analysis should incorporate ESG factors," the policy states, but only "to the extent that they affect risk and return."

AGF's AGFiQ Enhanced Global ESG Factor ETF appears to be a different case. Its prospectus doesn't say that the fund screens against fossil fuels but does commit to removing companies with "severe ESG controversies."

Nevertheless, Exxon Mobil, a company in court for allegedly lying about the impact on climate change to its business, was in its holdings.

When contacted, Mark Stacey, the head of AGFIQ Portfolio Management, wouldn't specifically comment on Exxon's inclusion.

"We are confident that the process we have in place will allow us to identify and mitigate the risks associated with ESG controversies in a timely and efficient manner," Stacey said.

With no ESG-specific organization dedicated to ensuring firms stay on task with their funds, regulation falls to the Ontario Securities Commission.

"Staff regularly conducts reviews of investment funds on a risk-based approach and assesses how they are fulfilling their stated investments objectives and strategies," said Raymond Chan, director of investment funds and structured products.

But the confusion around the sector remains.

Laura Nishikawa, managing director of ESG research at index provider MSCI, which has created more than 1,000 ESG indexes based on its rankings of 8,000 companies, doesn't think the variety of responsible investing choices is problematic. The use of "umbrella terms" are what is.

"I think what's a problem is the confusion around those choices and the use of these umbrella terms like 'ESG' or 'sustainable' that actually mean a lot of different things to a lot of different people," she said. "So that's an area where we've been working really hard to add that transparency."

Its an idea that Nash, the financial planner, agrees with. Because a variety of funds are presented in a similar and arguably flawed way, investors may wrongly believe they're ridding themselves of certain stocks.

Nash says he gets irritated each time he hears advertisements for Wealthsimple's socially responsible portfolio, which gives clients exposure to Suncor Energy Inc., because he knows how much the provider's idea of a responsible investing fund differs from his own.

"In that advertisement, they're setting themselves to the high bar that I know I want to achieve with my personal portfolio but having looked at the holdings inside, I know they fall so short of where my ethical bar is," Nash said.

A Wealthsimple spokesperson said the online investment manager's approach to responsible investing is to not eliminate sectors completely but to select the top companies in each one based on their ESG scores.

"We've approached it by building parameters around how we define socially responsible investing (through social, environment and governance factors), and how we believe the vast majority of people would want to see it represented," the spokesperson said in an email.

Nash's solution is to sit his clients down and open up portfolios of the funds to determine how strict his clients wish to be with their ESG integration.

The Post analysis found a number of options listed on the RIA's marketplace that may appeal to a traditional responsible investor. Horizons' Global Sustainability Leaders Index ETF, BMO's Sustainable Opportunities Global Equity Fund and a host of Stewart Investors funds, based on their top holdings, appeared free of fossil fuels and sin stocks.

"Investors just can't invest blindly. They need to ask questions. They need to look at the methodology of the fund they're buying and they need to take that extra step of looking at the underlying holdings," Nash said. "It is one of these things where the devil is in the details."

THE GLOBE AND MAIL

Golden blunders: How a string of technical mishaps has hampered Canada's junior gold miners; Reports overestimating the amount of gold led to junior miners flying high, but the gold was 'never there'

Niall McGee
17 July 2019

Junior gold-mining executive Scott Caldwell was in a jovial mood as he sat down for a national television interview in February, 2016.

Even though the price of gold bullion had tumbled by more than a third from its 2011 peak, and many of his competitors were struggling, his company was defying the odds.

Guyana Goldfields Inc. had managed to raise US$700-million from investors and put a high-grade gold mine into production in early 2016.

Mr. Caldwell, an avuncular mining engineer with a soothing tone, was happy to promote the company's Aurora mine, located in a remote Guyanese rainforest, as a cash machine.

Indeed, at the prevailing gold price of US$1,200 an ounce, Guyana looked like a surefire winner.

"A little less than US$800 an ounce [cost], US$400 an ounce margin," he said during a segment on Business News Network (BNN). "Pretty easy to figure out how we're going to do."

The company's share price soared as it ramped up production, and its market capitalization crested above $1.5-billion.

But last October, seemingly out of nowhere, the wheels came off. Guyana shed half its stock-market value in one trading session after the company raised doubts about the geology at Aurora. A technical report, upon which the mine was built, had vastly overestimated the amount and grade of gold at Aurora. This past March, Guyana cut its reserves by more than 40 per cent, after releasing an updated study on the mine. Guyana's chairman, René Marion, later admitted in an interview that some 1.5 million ounces of gold assumed by Guyana to be in the ground was "never there."

Ten months on, Guyana's share price is down 87 per cent from its peak. Its founder and almost its entire legacy management and board of directors have left. Mr. Caldwell will step down once a replacement is found. Nobody is sure whether the company can weather the crisis.

The meltdown at Guyana's isn't a one-off. Over the past few years, several other mining companies have shocked the market with nasty technical surprises.

Vancouver-based Pretium Resources Inc. has seen its share price whipsawed on multiple occasions by geological setbacks at its erratic Brucejack deposit in British Columbia; Toronto-based New Gold Inc. saw the economics of its Rainy River mine in northwest Ontario go up in smoke last year after it fell short on grade; and shareholders in Rubicon Minerals Inc. were almost completely wiped out after its deposit in Ontario's Red Lake camp turned out to be not mineable at all.

Virtually all of the incidents are occurring at technically demanding ore bodies that require exhaustive study.

While seniors, such as Goldcorp Inc. (now owned by Newmont Mining Corp.), haven't been immune from technical blunders, this is mostly a small company problem.

Many juniors have little or no experience in building mines and lack the technical talent that might head off calamities in advance.

Small mining companies rely heavily on external consulting firms that prepare resource models. The bigger companies have reams of inhouse talent – geologists, metallurgists and engineers – who vet the work of consultants. But juniors often don't have the same level of expertise to be able to push back if something seems off.

"[Smaller gold companies] don't have the human expertise to be able to steer away from those disasters. They don't have the technical bench strength. They don't have people that can look at it, and say 'hey this is wrong.' " said Andrew Kaip, mining analyst with BMO Nesbitt Burns Inc. "They're reliant on external advice and that can be flawed. It can have wildly bad outcomes."

The industry's recent flops also raise the issue of accountability when things go wrong. It's very easy to blame the consultant when the mine plan falls apart, but the management and boards of troubled companies, often responsible for making questionable decisions, are no angels either.

"In order for these things to collapse, half a dozen constituents of people have to not do their jobs," said John Tumazos, chief executive of New Jersey-based Very Independent Research. "And the reason they don't do their jobs is that no one wants to kill the golden goose, the gravy train. Even when the project sucks."

Compared with almost any other mineral, gold is a geological nightmare – harder to find, harder to model and harder to mine. There is no MRI machine for finding gold. Prospectors still have to identify a promising property, drill test holes, send samples to a lab for analysis and cross their fingers.

Even if you find gold, invariably there will be hardly any of it in the ore. The term "high grade" is actually misleading. Eight grams of gold in a tonne of rock is considered high grade. That's eight parts per million. Low grade is one part per million – a grain of salt in a giant bag of Doritos.

The gold industry is perhaps unrivalled in its wastefulness. A producer has to dig up about 20 tonnes of ore for enough gold to make a wedding ring.

Sometimes gold play nice, occurring as a fine powdery-like substance in rock, with consistent grades throughout the entire ore body – specks of salt uniformly spread across the Doritos. If drill samples confirm that consistency over and over, such deposits can be fairly straightforward to model.

But gold deposits can also be "nuggety" – low grade in most spots, but with the occasional high-grade cluster. And often there is no discernible pattern – like finding a random pretzel in the Doritos.

These ore bodies are among the toughest to model, because geologists can't be entirely sure whether the high-grade is a statistical fluke, or a pattern across the entire deposit.

Since it's financially feasible to drill only a tiny proportion of any potential gold deposit, experts have to take sample data and try to figure out what the rest holds.

Correctly modelling a mine, based on a sample that is perhaps only 0.13 per cent of the total mineralized rock, requires immense skill. Such work is typically done by a select group of independent mining consultants. Combining geological field work, and a branch of mathematics called geostatistics, the job is a blend of art, science and luck.

In 2012, SRK Consulting (Canada) Inc. produced a model for Guyana's Aurora property. Like all gold deposits, Aurora had its charms and its challenges. Early drilling revealed it was a little nuggety.

One way geologists deal with the presence of high-grade gold in what appears to be a mostly lower-grade deposit is to assume it's an anomaly. In constructing a geological model, consultants will routinely disregard high-grade drill samples above a certain level.

This practice, known as "capping," is supposed to prevent consultants from overestimating the overall average grade. But here's the rub. If a deposit is capped too low, that can kill the financial case for building the mine.

In 2012, SRK capped a section of Aurora, called Rory's Knoll, at 80 grams of gold per tonne. That meant Guyana could expect to find a certain amount of high-grade ore when it mined the area. But last year, as it mined Rory's Knoll, the high grade simply wasn't there.

"We weren't seeing the grade that we thought we would, based on the original 2012 model," Guyana's CEO, Mr. Caldwell, told The Globe and Mail earlier this year.

Guyana's chairman, Mr. Marion, pointed the finger squarely at SRK. The consultant was "very aggressive" in capping the deposit, he said.

Late last year, Guyana asked another consultant, Roscoe Postle Associates (RPA Inc.), to redo the technical report on Aurora from scratch. In its report issued in March, RPA capped Rory's Knoll at just 35 grams per tonne. Guyana's current management team maintains that RPA's capping is much more appropriate.

But SRK isn't taking any of this on the chin. The consultancy points the finger back at Guyana. After an internal review earlier this year, SRK concluded that its 2012 report on Aurora was technically sound based on data available at the time.

Adam Nott, general counsel with SRK, disputes any notion that the consultancy was aggressive in its modelling. The report was produced when Aurora was at an early stage, and was never meant to be relied upon for the construction of the mine, which came some four years later.

SRK would have had discussions with Guyana about the need to update the model and get lots more data before building Aurora. That would have required more drilling and the outlay of significant amounts of additional capital from Guyana. "For whatever reasons, internal to Guyana Gold, that update wasn't done until 2018, when new management came in," Mr. Nott said.

If SRK had access to the same data RPA did in 2018, including three years of actual mining, the consultancy "probably would have come to different results," he added.

Of course, any allegation that a consultant was too aggressive in its interpretation of the geology of a deposit hits a nerve in the Canadian mining industry.

Consultants are supposed to provide an unbiased and impartial view of an orebody. But the reality is more nuanced.

"Some [consultants] look at deposits and imagine all kinds of good things happening, and others, and we're among them, try to be more realistic," said Graham Farquharson, veteran mining consultant with Strathcona Mineral Services Ltd. in Toronto.

(In the late 1990s, when doubts arose about Bre-X Minerals Ltd.'s 70 million ounce gold find, the industry turned to Strathcona to investigate. Mr. Farquharson himself later made what he calls the "six-billion-dollar phone call," to Bre-x's board, definitively declaring Busang a hoax.)

There is also an inherent conflict of interest. Because consultants are paid by the mining companies, they face financial pressure to be positive. Having a negative stand on a project, even if it's spot on, can result in the consultant getting canned.

"It's a very hard battle telling your client that we think they need to go back to the drawing board," SRK's Mr. Nott says. "Especially when the clients know there are other consultants who are willing to use those [data points] and say that's within a reasonable range."

Mr. Nott added that SRK has lost work to rival consultants who were willing to provide a more bullish outlook on a deposit.

The technical reports themselves are also heavily influenced by clients. Consultants and management go back and forth on many issues, such as appropriate capping levels, the distance between drill holes and what long-term gold prices to assume in projecting returns.

Sometimes technical reports aren't as thorough as they could be, either, and that is often because of money. A client may not want to spend more on drilling and will choose to live with the added risk that entails. "SRK, in a lot of ways, is driven by what the client is willing to pay for, and what the client feels its risk-reward balance is," Mr. Nott said.

Most of the time, these kinds of behind-closed-doors discussions between consultants and mining companies are kept secret. But once in a while they become public. High up in the mountains of northwest British Columbia, Pretium Resource's Brucejack property was an enigma from the get-go. Early work in 2012 pointed to an extremely high-grade gold deposit. Some drill holes came back with as much as 41,000 grams of gold per tonne.

Despite extensive drilling, Brucejack was incredibly difficult to pin down. "You could come back with one sample that would have spectacular results and then 10 samples all around it that had nothing," said Mr. Farquharson, whose consultancy did a bulk sample on the deposit.

In 2013, Pretium shares shed half their value within two weeks after it revealed that Strathcona's analysis didn't square with a far more optimistic study by an Australian firm, Snowden Mining Industry Consultants. Strathcona insisted that Pretium disclose the discrepancy to its investors, then resigned in the aftermath.

Pretium, in turn, stuck with Snowden and trashed Strathcona's work as subpar.

Snowden felt Brucejack had similarities with deposits in the South Pacific with similarly eccentric geology. The consultant used a mathematical model called multiple indicator kriging (MIK) to predict the grade and location of the high-grade gold.

MIK is well suited to "mosaic" deposits such as Brucejack, where extremely high-grade gold occurs next to low grade, or even no grade, said international geologist Ashley Brown, who's now based in Kazakhstan. But MIK is extremely challenging. "The implementation of MIK is very difficult," he said. "It's easy to screw up."

What struck Mr. Brown as odd about Brucejack is that Snowden decided against capping the grade. By forgoing capping, Snowden allowed the pockets of high-grade gold samples to strongly influence the average grade for the entire deposit. Brucejack's reserve grade was pegged at 14.4 grams per tonne, which made it among the highest-grade gold mines in North America.

Snowden's approach didn't sit well with Haywood Securities Inc. analyst Kerry Smith, either. A former mining engineer, he's seen his fair share of geological goofs in his almost 40 years in the business. About four years ago, Mr. Smith attended an information session with Snowden about Brucejack.

"Snowden spent the whole day trying to rationalize why they should model it the way they did, which was basically to model those high-grade numbers and use them to influence the ore around it," Mr. Smith said. "I came away thinking 'I wouldn't do that. That makes no sense,' because these numbers are not going to have any continuity."

Mr. Smith was right to be wary. In January of last year, Pretium said Brucejack's grade was only corresponding 75 per cent to Snowden's model. The stock lost more than a quarter of its value.

"The high-grade mineralization was in narrower corridors than originally thought," Pretium CEO Joseph Ovsenek said in an interview.

Earlier this year, after undertaking a review of Brucejack, Pretium cut the mine's grade to 12.6 grams per tonne, increased its cost projections by 12 per cent and reduced its expected mine life by four years.

Snowden declined an interview request from The Globe. Ivor Jones, who had responsibility for the technical report on Brucejack, also declined to comment beyond saying, "It is easy to criticize other people's work. Especially something as challenging as Brucejack."

Pretium's CEO meantime refuses to play the blame game. Mr. Ovsenek instead points to the baffling geology, calling Brucejack a "beast."

"I can tell you from talking to a lot of people in the industry and others, there is no orebody like ours out there," he said. "I challenge anyone to say that they could have done better."

While Pretium has been wounded, even with a materially lower grade, Brucejack is still plenty profitable. Over the past 18 months, amid a recovery in bullion prices, the company's share price has regained most of its losses since early 2018.

The trouble for many other juniors is that they don't have deposits with grades that come anywhere close to Pretium's Brucejack, or the financial cushion to recover from geological setbacks.

It is possible for a gold producer to make lots of money from a low-grade mine if costs are kept in check and the geology is sound. But it’s crucial that there be a margin for error built in, in case things go wrong. Otherwise, a small slip can spell big trouble.

New Gold Inc.’s Rainy River mine is exhibit A.

Midway through 2018, less than a year into production, New Gold said it was seeing a roughly 11-per-cent shortfall in the grade at Rainy River. With that, the mine’s profit margin vanished.

New Gold also made a basic engineering error in designing the tailings dam at Rainy River and had to build a drastically strengthened structure. The episode blew its capital budget to smithereens.

New Gold now loses hundreds of dollars on every ounce of gold it produces at Rainy River, its debt load is US$780-million and it isn’t expected to produce any free cash flow until 2021.

“Some of these things should just never ever get built. That mine was one of them,” said Rob Cohen, manager of the Dynamic Precious Metals Fund.

If Rainy River’s economics were so dicey, why did it get built? A close reading of the mine’s technical report would have shown thin the margins were. The projected average grade was just 1.12 grams per tonne and the return on mine was forecast at 11 per cent.

But technical reports for the most part are impenetrable, and few investors are skilled enough to understand them. Reports can be penned by as many as a dozen authors, run 700 pages or more and are laced with terms such as “kriging” and “variogram.”

Here’s a passage from New Gold’s 713-page report in 2014, describing Rainy River: “The volcanic rocks have been intruded by a wide variety of plutonic rocks including synvolcanic tonalite-diorite-granodiorite batholiths, younger granodiorite batholiths, sanukitoid monzodiorite intrusions and monzogranite batholiths and plutons.”

The seeds of some mining disasters are buried in technical reports, there for the world to find them before a cent is spent on a mine. But these reports are written by geeks for geeks. The common investor doesn’t stand a chance.

New Gold declined an interview request for this story.

In addition to technical challenges, however, an old chestnut plays a role in some, if not all, of these cautionary tales. The gold industry is renowned for its culture of exaggeration, hype and promotion, and even the smartest among us can fall victim.

Gold mines are almost always built off a feasibility study (FS), which entails extensive drilling to confirm the existence of gold.

But Rubicon Minerals built its Phoenix underground mine in northern Ontario off a preliminary economic assessment – a much more rudimentary early stage study.

Despite the obviously materially higher risk profile, Rubicon raised more than half a billion dollars from investors. It even attracted one of Canada’s most sophisticated institutional money managers: The Canada Pension Plan Investment Board put $50-million into the miner.

In late 2015, mere months after starting production at Phoenix, Rubicon suddenly halted production, citing complications with the geology. Over time, it emerged that Rubicon hadn’t done nearly enough drilling to confirm the gold was actually in the ground. The company, which at one point was worth $1.2-billion, never recovered. Shareholders lost almost everything. In this case, they should have known better.

While most of these catastrophes involve small mining companies, there are a few outliers in the junior and intermediate sector that have demonstrated both geological prowess and sound judgment.

In 2011, junior gold company, Osisko Mining Inc. put what is now Canada’s biggest gold mine into production. While the Canadian Malartic mine in Quebec is low grade, it is very profitable.

The technical team behind Osisko did their homework, including drilling the deposit like crazy. Two of the company’s top three executives were geologists and the other was a mining engineer. (Osisko was acquired by Agnico Eagle Mines Ltd. and Yamana Gold Inc. for $3.9-billion in 2014).

Vancouver-based B2Gold Corp. is another example. Founded in 2007, the company acquired, developed and built Fekola in Mali, now one of the world's most profitable gold mines. Instead of outsourcing mine construction to external engineering firms, as is industry practice, B2 builds its own mines with a tight-knit staff CEO Clive Johnson has worked with for decades.

But of all of Canada's gold miners, Toronto-based senior Agnico Eagle Mines probably has the strongest reputation for technical excellence over the long term. Over more than 60 years, the company has never experienced a serious geology mistake, despite dealing with many technically demanding orebodies.

To access ore at its LaRonde mine in Quebec, the company mines three kilometres underground. Agnico built two mines in Nunavut, despite having no access to power, or roads, and operating in a brutally harsh climate. In Finland, the company deals with complex metallurgy.

Agnico is known for its conservative approach. It's stacked with technical staff, and renowned for its airtight chain of command that starts at the top, with CEO Sean Boyd, and extends through the entire organization.

"Sean Boyd knows how to delegate responsibility. He understands the importance of his technical guys, understands about getting the mine engineers talking to the metallurgist, talking to the electricians. Everyone," Dynamic's Mr. Cohen said.

"That's what brings success to these projects. Having a sharp pencil and being no nonsense."

A decade ago, Pretium, Guyana Goldfields and New Gold might well have been bought by a bigger miner, well before major problems occurred. Within a technically stronger and better capitalized senior, basic geology mistakes could have been averted or minimized.

But in 2012, the mergers and acquisitions (M&A) market in mining went into a deep freeze. A vicious gold bear market in the first half of this decade, and terribly timed acquisitions during the last bull market, forced the majors onto the sidelines.

Smaller companies have been forced to hang around as standalones longer than before. That has forced many of them into the uncomfortable terrain of building mines by themselves – often for the first time.

The risk of something going wrong was always going to be higher. While M&A has taken off again in a limited way among the seniors, for the most part it's crickets further down the ladder. If that dynamic doesn't change, more mines will invariably be built by the tenderfoot, and investors will be left to wonder where the next geological shock lies.

Follow this link to view this story on globeandmail.com: Golden blunders: How a string of technical mishaps has hampered Canada's junior gold miners The viewing of this article is only available to Globe Unlimited subscribers.

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