3 Stocks That Play to Canada's Strengths

Description

Are you familiar with **First Trust Canadian Capital Strength ETF** (TSX:FST)?

It converted to an ETF from a mutual fund on November 16, 2016. One of three actively managed ETFs at First Trust, FST is up 7.5% year to date, 670 basis points higher than the **S&P 500**.

The ETF, although actively managed, uses a relatively straight-forward portfolio selection process that identifies Canadian stocks or companies with significant operations in Canada and that have excellent balance sheets.

The criteria include good cash holdings ($75 million or higher), minimal debt (less than 40% debt to market cap), excellent returns on equity (10% or higher), good cash flow, good liquidity, and trade at reasonable valuations.

You can buy the ETF

The easiest way to benefit from this process is to buy the ETF, which has an annual MER of 0.66% and currently holds 26 stocks. The three top holdings as of July 21 are **Linamar Corp.** (TSX:LNR) at 4.28%, **Saputo Inc.** (TSX:SAP) at 4.14%, and **Great Canadian Gaming Corp.** (TSX:GC) at 4.06%.

I recommended Great Canadian Gaming in October 2016. I'm a little skeptical about Saputo, since its stock has appreciated in the past three years, but I still believe it's a good stock. Finally, Linamar has remained a value play since last October when I recommended it. It has an 8.7% free cash flow yield — the same as nine months ago, despite gaining nearly 30% since. It deserves to be the number one holding.

Three-step process

The alternative to owning the ETF is to do a quick screen for potential companies that fit the quantitative portion of the ETF's portfolio construction process, which includes more than $75 million in cash, debt less than 40% of market cap, and a return on equity (ROE) of more than 10%.

The stocks I'm looking for must trade on the TSX, have a share price above $10, a market cap of at least $500 million, and three-year profit growth of at least 10%.

That gives me 74 stocks. To narrow that down even further, I'll start with the stocks with the highest interest coverage (a sign of good cash flow and lower debt) and work back from there.

Here are my three picks

1. **Winpak Ltd.** (TSX:WPK) has no debt, US$232 million in cash, and a ROE of 15.5%. Funnily enough, it's one of the First Trust ETF's holdings at 3.97%.

2. **Enghouse Systems Limited** (TSX:ENGH) has $2 million in debt, $88 million in cash, and a ROE of 18.5%. Enghouse was one of five "special" companies I highlighted back in February. It's had some ups and downs since then, but long term, it's a solid buy.

3. **Magna International Inc.** (TSX:MG)(NYSE:MGA) has US$2.4 billion in debt (13.9% of market cap), US$831 million in cash, and a ROE of 21.0%. Magna, like Linamar, is also a part of FST with a weighting of 3.93%. If you bet on one, it makes sense to bet on the other.

Bottom line

Of the 74 stocks that made the cut based on market cap, share price, and growth, only 54 have an ROE that's 10% or more. The three picks from above might not have the highest ROEs of the 74, but they're healthy.

Now, find 17 others, and you've got the makings of an excellent portfolio of Canadian stocks. Or maybe you don't and just buy the ETF instead.

Good luck.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:MGA (Magna International Inc.)
2. TSX:LNR (Linamar Corporation)
3. TSX:MG (Magna International Inc.)
4. TSX:SAP (Saputo Inc.)
5. TSX:WPK (Winpak Ltd.)

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