Should You Invest in Canada?

Warren Buffett just bought stock in a Canadian mortgage underwriter, Home Capital Group. Should you invest in Canada when the Oracle of Omaha does? An article in *The New York Times* discusses why you should not go where **Warren Buffett invests** in this case.

> *When Warren Buffett acts, investors notice. And after he took a roughly $300 million position last month in Home Capital Group, a troubled Canadian mortgage underwriter, some investors saw it as a vote of confidence not only in that company, but also in Canadian stocks over all.*
>
> *Al Rosen takes a different view. A veteran forensic accountant and independent equity analyst who predicted the collapse of Nortel Networks, the Canadian telecom company, two years before its 2009 demise, Mr. Rosen has a message for people investing in Canadian stocks: be wary.*

The issue according to Mr. Rosen is Canadian accounting rules.

> *International accounting rules followed by Canadian companies since 2011 are putting investors in Canadian stocks – not just Home Capital Group's – at peril. Canada's rules, which are substantially different from the generally accepted accounting principles (G.A.A.P.) governing American companies, give much more leeway to corporate managers when it comes to valuing assets and recording cash flows.*

Inaccurate information about the financial health of companies was at the root of the 2008 market crash and financial collapse. We repeatedly suggest that investors learn to calculate and apply **intrinsic stock value** when deciding when to buy, hold or sell stocks.

> *Here is the original formula that Benjamin Graham suggested as modified in 1962 and again in 1974.*
>
> *Preceding twelve months earnings per share, EPS*
> *A constant of 8.5 representing an expected price to earnings ratio, P/E ratio, for a company that is not growing*
> *g being an estimate of long term growth (five years)*
> *A constant = 4.4, the average yield of high grade corporate bonds in the early 1960 decade*
> *Y = The current yield of AAA corporate bonds*
> *V = intrinsic value*

The formula is as follows:
V = (EPS x (8.5 + 2g) x 4.4)/Y

Once the investor has determined the intrinsic value of a stock he compares that number to the current market price. Intrinsic value divided by current price is referred to as the Relative Graham Value or RGV. An RGV of more than one indicates a buy and an RGV of less than one indicates that one should ignore the stock or sell if it is already in one's portfolio.

However, for this sort of fundamental analysis to work in your favor you need accurate information about the company whose stock you might or might not purchase. If you are considering investments in Canadian stocks read the *Times* article as it explains in depth some of the accounting issues that may make these investments seem more attractive than they really are.

An Alternative View

Seeking Alpha suggests **twenty Canadian stocks** that it says are high quality.

The S&P/TSX Composite Index in Canada is dominated by two sectors (financials and energy).

To combat this problem, one could create an equally weighted portfolio of 20 stocks (2 from each sector, excluding healthcare).

The resulting portfolio is well diversified and has significantly outperformed the index over the last 6 and 12 months.

Diversification is one way to avoid being fooled by faulty accounting info.

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