

## Laketon Enhanced Dividend

Recorded: August 25, 2009

**Milos:** Hello and welcome to our listeners tuning in to our continuing series of Laketon Manager audio commentaries. This is the first audio session following our summer break period and we welcome once again Brad Cann, Vice President and portfolio manager of the Canada Life Enhanced Dividend Fund.

Brad, needless to say, we have seen stellar returns for the S&P/TSX since early March of this year almost 40% to date. Which begs the question, should we be nervous about these kinds of advances, are the Canadian economic fundamentals and company earnings environment sending a different message? In addition are you expecting market pullback/corrections and if so, are we still in your opinion going to experience movements sideways as investors and the market look for traction and any good news day to day?

**Brad:** Thank you, Milos. After a long trying period in the equity markets, it is very comforting to experience once again that markets can go up, in addition to that other direction. It is our belief as well, that the systemic risk that was clearly being priced into the market last winter, especially in the financial shares, has been for the most part, taken off the table.

I believe it is always prudent to view rapid gains in the market with a little scepticism, but, you know Milos, with how far the market had fallen, we should not be that surprised, that when the sentiment turned, we would see a larger than normal gain, for at least a period of time. Having witnessed that, we now believe that the market needs some confirmation in the form of improving earnings and, sales in some cases, to justify or even maintain, the valuations we have re-attained.

As for market volatility, we should expect the equity markets to experience a further bout of jitters -- generally speaking, that is the nature of the beast, but we also believe the extraordinary moves are behind us for this cycle. I will say, that after having enjoyed positive returns now since March for Canadian equities, some consolidation or retreat cannot be ruled out in the near future, setting the stage for an additional meaningful advance as the economy recovers.

**Milos:** Brad, no discussion with you would be complete without reference to the banks and their current state of health and profitability. Can you give the listeners a sense of where the Canadian banking sector stands today and if you could mention any particular bright spots or areas of concern that you are focusing on at present?

**Brad:** Milos, a very timely question actually, almost too timely in that our banks are just beginning to report their 3<sup>rd</sup> quarter results-starting today with, the Bank of Montreal so I may have to further update your listeners in the near future.

Nevertheless, I will speak to my broad overview of the Canadian banking sector at this juncture. The Canadian banks have actually weathered this storm admirably, such that they have become, in some quarters and I do not believe I am stating this too strongly, the envy of the world. It is not to say that there have been zero trouble spots, but we are referring to a comparison that is relative to so many of the other banks around the globe.

A bright spot for our banks is that there have been no dividend cuts and capital positions of the banks generally have been bolstered significantly, making the odds of cuts very tiny. Obviously, in this recessionary period, which includes high unemployment levels, feeble economic growth, and certain industries struggling for survival, there are areas of the banks' loan books that cause us some concern. To deal with this, we try to keep as close a watch over the trouble spots as the public data allows us.

I should say that since the equity markets have discounted some of these strong points, we would not be surprised if bank valuations pause in their upward movement for a period of time.

**Milos:** Bank Dividends and preferred share dividends are an integral part of the Enhanced Dividend Fund. Can you comment on how the dividend and yield levels have performed since our last February discussion earlier this year?

**Brad:** What's a dividend talk, without a yield discussion?

Last winter when the market was grappling with whether President Obama's and Treasury Secretary Geithner's stimulus plans would work, I mentioned in talks that dividends were "on sale"-- that is to say, it took a lot less capital to buy \$1 of dividend income. To give listeners an example, back then, the Bank of Montreal or BMO stock cost about \$25 per share and it paid an annual dividend of \$2.80 for a juicy 11% yield. Fast forward to today, the same shares, with the same dividend cost \$50 or double. Therefore, the current yield has declined to 5.6%, roughly half that a mere 6 months ago. I will not go through other examples, but the similar math applies to the other Canadian bank stocks, as well as some other dividend payers.

In a nutshell, this Fund's strategy is to buy, own and grow a set of dividends and compound them over time to grow our clients' ending wealth with acceptable risk. This past winter was a great time to be a purchaser of dividends. Today, it is obviously more expensive to be a buyer of yield but I continue to hunt for companies that will increase their dividend payments over time, to help provide the returns we look for.

My last recording touched on our positive view of the sustainability of bank dividends so I will not repeat it here Milos. But now to complete the picture for our listeners, The Fund's current yield is 4.5% overall, historically quite high relative to yields available in the bond market. And that yield is comprised of 4.5% on the common equities in the Fund and an average of 5.9% on the preferred share portion, offset by a less than 1% yield on the relatively small cash balances we currently hold. I won't dwell on it, but obviously last March, these yields were much higher.

**Milos:** Brad, could you please give our listeners a sense of how the Enhanced Dividend Fund is positioned in terms of overall sector weightings and why?

**Brad:** Sure Milos, fund positioning is critical to the fund's success and takes up a fair amount of my, quote---un-quote---thinking time. Just so we have a context for the discussion, the TSX benchmark for Canadian equities has 3 large sector weightings that make up three quarters of the benchmark, Financials at roughly 30%, Energy at 28% and the Materials at 18%.

By comparison, our Enhanced Dividend Fund currently has over 40% in Financials in its common equity portion, only 12% Energy and no Materials exposure, but also includes a large 15% in telecom services. The Fund also currently holds about 15% preferred shares and 7% cash equivalents. Remember, our mandate is to invest where dividends are paid, similar to when a mining company says "to discover the next gold ore body, we have to explore where mother-nature deposits the gold"

So, why do we believe in this positioning today? Well, we hold a substantial financials weighting, to take advantage of their continuing attractive yields and profit outlook. The Canadian banks have not, and I

believe will not this cycle, trim their dividends. And despite lower yields than earlier this spring, they remain attractive relative to current bond yields.

Our overweighting in the Telecom and Utilities sectors is no accident. We believe both these sectors have attributes that make the companies relatively resistant to, although not immune to, the impacts of the recessionary economic climate we now find ourselves in. What do we mean? Well, they supply very basic services like electric power, phone service, cable TV and the like that end customers only stop using as a last resort. As a consequence, revenues are less affected by the slower economic growth than other sectors. In addition, cash flows are more stable, resulting in constant or even growing dividend payments. One additional point is that these types of companies are regarded by many investors as a boring place to invest, and therefore they tend not to get wildly over-valued in bull markets. Case in point, these types of stocks have lagged the overall TSX advance since March.

Milos, I would be remiss if I did not mention our preferred share investments. These were mainly acquired as part of our overall defensive posturing in late 2007 as we felt common equities were expensive. They also help to balance off the common equity exposure in our Fund given our more conservative mandate. We are comfortable with our current weighting of 15% and we would only likely lower that, in favour of common shares, when the economic picture gets a great deal clearer.

Finally, it is still our belief that, in the lower return environment that appears to be shaping up for the coming years, dividends will play a more significant part of an investors' overall returns. This is music to our ears as we intend to continue reaping the rewards for our investors using the magic of compounding.

Now back to you Milos.

**Milos:** Brad, thanks as always for your comments and insight, I hope that we can have you back in the near future.

Please tune in next month for continued commentary from our portfolio managers, these audio commentaries can be found on our website at **[www.laketon.com](http://www.laketon.com)**