

Laketon Enhanced Dividend Fund

Recorded: December 16, 2009

John: Hello and thank you for joining us for this month's audio commentary. My name is John Slattery, and I am president of Laketon Investment Management. Before I introduce our guest speaker, I would first like to wish you and yours all the very best for the year ahead.

The question of the day is what to expect with the year ahead. Before we address that, we will first review where we have come from. To do that we are fortunate to have with us today, Brad Cann, Vice President and Portfolio Manager of the Laketon Dividend Fund. The title of today's commentary, "What a difference a year makes."

Brad, I'd like to begin by asking your view on where we are in the equity cycle. As you know, we have had a savage correction that has subsequently been followed by a very impressive rally. Is it over or is there more to come?

Brad: Thanks John, a good way to begin the new year is with a brief recap on the markets. A few numbers should help us set the scene

2009 began with the TSX just below 9000 and we promptly resumed the Fall slump to reach a low of 7480 in March -recall the market's top in June 08 was just over 15,000, so we experienced a 50% drop in just over half a year

From there, the market rallied, with minor sell-offs, from mid March until year-end, reaching roughly 11,800 in December, a whopping 58% above the lows.

Moves of this magnitude inside a calendar year, are not the norm, but they do demonstrate how drastically the economic outlook changed—going from a reasonably buoyant view in June '08, to a situation where economic activity was free-falling without a bottom. Suddenly, there was no safe equity anywhere in the world.

So where are we now? Broadly speaking, I am becoming optimistic that the worst is behind us and we improve from here. I do believe the progress will be weaker than most recoveries due to the shaken confidence of the US consumer, and the level of government intervention that occurred with this downturn.

As for the equity markets, I believe this likely means more muted returns post this initial bounce.

John: Brad, I would like to get a bit more specific and focus on a sector that's significant to your fund, the financials. Given the fallout and negative publicity from the near collapse of the world banking system, will the new capital rules impede dividend increases from the Canadian banks?

Brad: The Canadian banks are being very cautious in preserving their capital currently as we all await the regulatory response to the world-wide financial meltdown. We believe our banks will measure up quite well once we know the new capital regulations. Having said that, given what the Board of Directors witnessed, I am expecting a cautious approach to dividend increases in the next 12-18 months. So while increases may be hard to come by, my belief is that current dividend yields provide an acceptable level of return relative to current interest rates.

John: Brad, when evaluating a firm's ability to meet its dividend obligations, what evaluation metrics do you rely most on?

Brad: That's a great question John --the payout ratio, or the percentage of a company's earnings that the dividend represents is a first stop, along with the company's policy on dividends.

But I also like to dig deeper—for instance, one important consideration is the strength of the company's balance sheet. So, I question whether the level of debt is manageable relative to the size and steadiness, of the company's cash flows. What helps out here is knowledge of the type of industry in which the company operates.

For example, is the product or service an everyday or regular purchase, or an infrequent, luxury item that can easily be delayed or avoided altogether.

Finally, I'd to consider the company's track record on dividends and use of capital, and then try to anticipate how the Board of Directors would tackle their decision.

John: Brad, has your recent research identified any sectors or specific companies that have caught your attention?

Brad: I hate to be a broken record here John, but even though the banks have had a great run, from the lows when one looks at a gradually improving economy, and the earnings estimates for 2011, which is what the market looks to at this point, I believe the Canadian banks are not very expensive. They should provide investors with good returns at moderate risk, when you include the dividends paid. I also believe the utilities and telecommunications sectors, which have lagged in this equity rally, provide a good opportunity.

Specifically, Fortis, a gas and electric distribution utility, has certainly come onto my radar screen. It's share price has not moved much in the last 4 years, despite arguably improving its businesses since that time. It has a track record of growing its dividend over time and it is a company that has been sticking to its knitting—a feature that I admire and which I believe keeps risks at a reasonable level.

John: Brad, historically you have liked preferreds. Do you continue to think they have a role in your portfolio?

Brad: Absolutely, I do. They often reduce portfolio risks and thereby act as a stabilizer for portfolio values. In addition, they pay quite handsome dividends compared to the rates available on bonds or T-bills.

John: As a follow up Brad, while preferreds tend to hold up better than the corresponding common stock, in down markets; was that the case in the recent downturn?

Brad: Yes and no. If one merely calculates the percentage drop, they did hold up slightly better than common equities. The average preferred share dropped by about 20%, whereas most common stocks dropped in an excess of 30%. On the other hand, preferreds did not provide the kind of defense I had grown accustomed to over the years.

The main reasons I believe were 2 fold—first, many outstanding prefs are issued by financial firms whose ongoing viability was being questioned by the markets at the cycle low, and secondly, the depth of the downturn in the markets combined with the quest for instant liquidity, led to the indiscriminate selling of all sorts of quality securities merely due to the mentality that “only T-bills were safe.”

John: Brad, does the current low level of interest rates make dividend paying stocks more or less attractive?

Brad: Pure math would tell us that the dividend yields are very attractive relative to the low interest rates paid on bonds, just not as attractive as they were in March or April of 09. For me, the judgment required now has to do with how much of your capital is at risk given the rally and how the securities will respond to rising interest rates. That's the key.

John: Brad I would now like to finish up with one last interest rate related question. If interest rates start to rise, how would that effect the market in general and dividend paying stocks in particular?

Brad: An excellent question to finish with John, as surely it is the \$64,000 question for 2010.-- And I would paraphrase- When, not if.

Generally speaking- as the cost of money, or the interest rate, rises, the opportunity cost of holding stocks rises— as well, the discount rate that investors use to value cash flows rises, lowering the “present value” of those cash flows—So, it means, that most equities will not rise as quickly, or might even fall, compared to when rates were lower. I do not believe I have seen any clear evidence as to whether dividend paying equities are more, or less, affected from these impacts.

A couple of other points if I may.

There is an offset to the higher rates for equity investors. One reason rates increase is due to improving business conditions, allowing companies to sell more, earn more and therefore, any discounting is performed against larger cash flows. As well, bond prices move lower with higher rates. So there may be a trade-off for investors- And that, my friends, shows investing is not such a precise science--

So John, to be very clear, if the recovery continues, investors should expect interest rates to be on the rise fairly soon.

John: Thank you Brad for your comments and discussion today, and we certainly look forward to hearing from you in future. I would also like to remind our listeners that the Laketon website is a source of varied and useful information. In addition to the audio files, you can gain access to our quarterly fund commentaries for any of the Laketon funds. If you can't find what you need, I encourage you to please contact us and let us know how we can help you. May 2010 be profitable to us all, and again thank you and until next time goodbye.