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Portfolio Update – Empire Life's Dividend Growth Fund

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The purpose of this commentary is to provide insight into how Empire Life's Dividend Growth Fund was repositioned since I was appointed lead manager approximately two years ago. As a reminder, my primary objective was to reduce the fund's exposure to cyclical stocks, which made up a significant part of the portfolio two years ago, and opportunistically increase exposure to high quality defensive growth companies that are less sensitive to macroeconomic factors. In making these changes, the fund also carefully considered sector, regional, and foreign currency exposure to ensure proper diversification. The fund was fully re-positioned, mostly consisting of high-quality defensive growth companies, as of the first quarter of 2020.

The fund was re-constructed with the intention of downside protection through difficult markets and to generate attractive absolute returns in a strong equity market such as the one we have experienced over the past year. Changes made to the fund during the summer months have made the fund even more defensive. Some of these changes include trimming financials and energy names (and tilting the fund's energy exposure more defensively) which has probably weighed on performance relative to peers over the past couple of months. In my view, this was the prudent course of action to take considering how far along we are in the equity market recovery and the numerous macroeconomic risks on the horizon.

A Focus on High Quality Companies

Before highlighting some of the major changes to the fund and touching on positioning, I would like to identify the key attributes of a high-quality defensive growth company which the fund will only invest in at an appropriate discount to fair value:

1. A good management team with an established track record.
2. A strong balance sheet.
3. A sustainable competitive advantage which allows the business to consistently generate returns on invested capital above its cost of capital.
4. Visible - and attractive - medium-term growth prospects underpinned by a combination of growing/defensive end-markets and market share gains.
5. Strong and consistent free cash flow generation. Dividend yield is important but more imperative is a company's capacity to increase dividends through the economic cycle supported by the aforementioned attributes and a low dividend payout ratio.

High quality defensive growth companies as described above made up ~18% of the fund two years ago versus over ~65% today. It is important to highlight that the ~65% number does not include the Canadian banks which comprise ~22% of the fund today versus ~18% two years ago. While Canadian banks can experience short term earnings volatility, over the medium term and through the economic cycle, they have consistently generated robust bottom-line growth at attractive returns because of their dominant competitive positioning. As a result, trading around the Canadian banks (buying when they are out of favour and selling when they are in favour) is the approach the fund takes with this sub-segment of the financial sector. As an example, during the COVID-19 related equity market sell-off in March of 2020, the fund added to its Canadian bank holdings. Today, after significant outperformance of the Canadian bank stocks over the past year - and higher valuations - the fund has selectively reduced its exposure. We still anticipate attractive total returns from the Canadian banks but less so versus one year ago.

Repositioning the Fund

A key component of the fund's repositioning was lowering its energy exposure and shifting the exposure to more defensive areas of the energy sector. Today, energy makes up ~14% of the fund with 65% allocated to defensive energy stocks versus two years ago when nearly 20% of the fund was invested in energy with only ~25% allocated to defensive energy stocks. Enbridge and TC Energy - which combined make up ~7% of the fund today - are good examples of defensive energy stocks. Despite WTI oil prices falling into negative territory in 2020 (as a result of COVID-19 and the OPEC+ price war), both companies managed to hold adjusted earnings relatively flat in 2020 and grow their dividends which are currently yielding ~6-7%. While we continue to have a constructive view on oil prices in the very short term, after the strong rally in oil and energy equity prices over the past few months the fund has shifted even more of its energy exposure to defensive energy stocks.

The fund had no exposure to technology when I took over management two years ago; today, it has ~9.5% exposure.[1] For example, the fund started a position in Alphabet (GOOG) in the summer of 2019 and more recently added Facebook. In Canada, the fund owns CGI Inc. and Open Text. GOOG is a great example of opportunistically buying a high- quality company – when the fund initiated a position in GOOG it was trading at only 17-18x earnings (and a substantial discount to fair value) due to antitrust concerns and slower than expected quarterly growth. Since the fund began buying GOOG, its earnings multiple expanded to ~22x and the stock has appreciated by ~150% versus the fund's cost base. Today, Facebook trades at ~18x earnings which we believe provides compelling value considering the company's dominant competitive positioning in social media advertising, the durability of its business model, and its attractive organic growth prospects in the mid to high teens range.

[1] Includes Alphabet and Facebook which are classified as communication services under GICS.

The fund had no health care exposure two years ago versus ~4.5% today which includes Johnson & Johnson (JNJ), and more recently Merck & Co. The fund added JNJ in the Fall of 2019 at 14-15x earnings and a 3% dividend yield – prior to adding JNJ the stock had underperformed due to concerns related legal liabilities stemming from its baby powder product and the opioid crisis. Our view was that the uncertainty surrounding these legal liabilities was more than reflected in the stock's valuation and the market was underappreciating the company's strong and well diversified pharmaceutical segment which underpinned good visibility of high single digit organic earnings growth. JNJ's stock has since re-rated to ~16x earnings and has generated a total return of nearly 30% since the fund initiated a position. JNJ also increased its dividend through the COVID-19 pandemic.

Recent Updates

Merck & Co is a relatively recent addition to the fund – we see compelling value with the stock trading at ~13x earnings and offering a ~3.5% dividend yield. One of its major drugs, Keytruda, is coming off patent in roughly five years but until then there is very good visibility of low-teens organic earnings growth supported by its existing portfolio of drugs. Moreover, we believe that through M&A and internal research and development that Merck & Co is well positioned to fill the eventual earnings void from Keytruda coming off patent. At today's valuation, the market appears to be paying nothing for growth ex-Keytruda which we believe provides a compelling risk reward proposition.

The fund's non-Canadian exposure is just over 27% today versus 17% two years ago – taking advantage of the fund's maximum 30% non-Canadian exposure was an important enabler of adding high quality companies at attractive valuations. I have already cited a few examples in the United States, but the fund has also found opportunities outside of North America, including the UK, Continental Europe, and Japan which collectively make up nearly 14% of the fund. As an example, the fund started a position in the global UK based alcoholic beverage company, Diageo PLC, during the depths of the COVID-19 related market sell-off in the first half of 2020. Understandably, there were concerns that this very high-quality defensive business would face material headwinds from the closing of bars and restaurants, but we saw this as an opportunity taking a longer-term view. In local currency, Diageo's stock has returned ~30% versus the fund's cost base.

The fund benefited from two take-overs this year including Shaw and WPT Industrial. As a reminder, in March of 2021 Rogers announced a $40.50/share bid for Shaw which at the time was a ~70% premium to Shaw's stock price. Shaw was a top weight in the Dividend Growth Fund prior to Rogers' bid – I have since exited the position seeing better opportunities elsewhere. More recently in August of 2021, Blackstone Real Estate Investment Trust bid $22/share for WPT Industrial which represented a ~17% premium to the share price at the time. WPT Industrial was the fund's top real estate holding prior to the announcement of the deal.

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Summary

In summary, I feel confident about how Empire Life's Dividend Growth Fund is positioned today, being primarily composed of high-quality defensive growth companies poised to sustainably increase dividends through the economic cycle. The fund opportunistically and selectively added these types of companies by taking advantage of market dislocations which meant that the fund was not fully repositioned until the first quarter of 2020. Lastly, the Empire Life Dividend Growth Fund's focus on high quality defensive growth companies coupled with proper diversification makes it a suitable way to gain conservative exposure to both Canadian and global equities. As always, thank you for your continued support.

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