

Portfolio Update – Empire Life’s Dividend Growth Fund

By Doug Cooper, Sr. Portfolio Manager, Canadian Equities
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Below are a few key highlights and thoughts related to Empire Life’s Dividend Growth Fund.

Since becoming lead manager of the fund in June of 2019, my primary objective has been to transition it primarily to high quality defensive growth companies that possess greater visibility of medium term free cash flow and dividend growth. This was a structural change in the portfolio that was mostly completed during the first quarter of 2020.

Another objective of the fund was to increase its global exposure through non-Canadian stocks and global businesses domiciled in Canada. Today, ~24% of the fund is invested in global stocks (up from ~17% in June 2019 but still below the 30% limit) and ~60% of the fund’s revenue is generated outside of Canada when factoring in global companies domiciled in Canada. Therefore, the fund provides a good balance between Canadian and global exposure. I expect the fund’s global exposure to increase further as it takes advantage of the larger investment universe outside of Canada and continues to focus on global companies domiciled in Canada.

While high quality value and dividend stocks underperformed for most of 2020, this trend reversed sharply in November as the market gained visibility on a positive inflection point in global growth supported by the rollout of COVID-19 vaccines. Moreover, record levels of fiscal and monetary stimulus globally supported (and in some cases strengthened) personal and corporate balance sheets through the COVID-19 related lockdowns, setting the stage for a massive unleashing of expected pent up demand and inventory restocking as lockdown restrictions ease. As we employ a value based investment style in the fund, relative and absolute fund performance improved significantly in the back half of 2020 when the fund returned +14.8% and outperformed 90% of its peers (source: Morningstar).

Top contributors to fund performance in 2020 include Stella Jones Inc., Alphabet Inc., Canadian National Railway Inc., Restaurant Brands Inc., and Booking Holdings Inc. Top detractors from fund performance during this time period include Cenovus Inc., Brookfield Properties Inc., New Flyer Inc., Keyera Inc., and Canadian Natural Resources Inc.

A historically high valuation discount between value stocks (as well as dividend stocks) and growth stocks that widened through most of 2020 was also a catalyst for the sharp rally in high quality value and dividend stocks starting in November 2020. This valuation gap has closed over the past few months but still remains high (i.e. we continue to see a lot of value across the fund’s holdings – more on this later).

The rapid global roll out of COVID-19 vaccines provides increasing visibility of an anticipated rebound in economic activity. The timing of this economic rebound is somewhat uncertain but it is likely only a matter of time once herd immunity is reached through both infection and vaccines. Canadian equities, in particular financials and energy, are well positioned to outperform in an environment where economic activity rebounds sharply. We have already seen a sharp rally in Canadian financials (banks,

life insurance companies, and alternative asset managers) since November 2020¹ but this is likely to continue considering attractive valuations and the positive drivers for these businesses in a period of accelerating economic growth.

Today, Financials make up the largest sector weight in the Dividend Growth Fund at ~34% consisting mostly of the Canadian Banks with Bank of Nova Scotia, Toronto Dominion and Royal Bank as top weights. Brookfield Asset Management is also a significant weight in the fund as well as Manulife.

Oil prices have moved much higher year-to-date (up ~26% as of February 26, 2021) due to favourable supply side dynamics including OPEC+ managing supply aggressively with good compliance across the members; and producers globally demonstrating strong capital discipline as a result of shareholder pressure. Also, the market is looking forward to accelerating economic growth in a post COVID-19 world which bodes well for oil demand. More recently, unusually cold weather in Texas, which stopped a significant amount of US oil production, has propelled WTI oil prices even higher above \$60.

The fund continues to have a conservative positioning in energy at ~14% of the fund primarily in utility-like pipelines including TC Energy and Enbridge both of which are trading at historically low valuations levels not seen since the early 2000s. We view this as very attractive considering the utility-like attributes of these businesses and attractive growth prospects in the high single digit range which coupled with mid to high single digit dividend yields provides attractive total return prospects.

Recent activity levels have picked up in the fund primarily from reducing/exiting positions in stocks that have outperformed through the COVID-19 crisis either because of their resiliency or due to the market pricing in a sharp recovery in earnings growth once COVID-19 related headwinds abate. Examples of the former include Japan based Shimano which is the world's largest bicycle parts manufacturer, and Nitori which is Japan's dominant discount furniture retailer. Products from Shimano and Nitori have been in high demand through the COVID-19 related lockdowns. Booking Holdings Inc. and Gildan Activewear Inc. are two examples of stocks in the fund that benefited from the market pricing in a sharp recovery in earnings growth in a post COVID-19 world. We exited the former position and trimmed the latter entirely due to valuation which has expanded to what we viewed as unattractive levels.

In addition to Canadian financials and pipelines, the fund is finding opportunities in other sectors including technology, industrials and consumer both in Canada and globally. A few examples include Canada based IT services company, CGI Inc.; Canadian based global leading engineer company, Stantec Inc.; France based transportation infrastructure company, Vinci SA, which earns concessions on motorways and airports; and UK based beverage company Britvic PLC. In all cases, the shares of these companies were bought at attractive valuations; and each business has varying degrees of torque to acceleration in economic activity. Finally, all four of these companies possess defensive growth attributes, and a strong competitive positioning which provides good visibility on attractive industry leading growth.

¹ The share prices of the big six Canadian banks were +27.1% on average from Oct 30, 2020 to Feb 26, 2021: Bank of Nova Scotia +34.4%, Toronto Dominion Bank +32.5%, Royal Bank of Canada +17.5%, Bank of Montreal +32.4%, CIBC +19.5%, and National Bank +26.5%. Over the same time period Manulife was +43.6% and Brookfield Asset Management was +30.6% versus the S&P/TSX +17%.

In summary, the repositioning of the Empire Life Dividend Growth Fund, coupled with a sharp rally in high quality value and dividend stocks late last year, resulted in strong fund performance in the back half of 2020. The fund has been active in recent months, positioning to take advantage of what we expect to be a sharp acceleration in economic growth as economies open in a post COVID-19 world. We feel very good about how the fund is structured today consisting of attractively valued high quality defensive growth companies that are well positioned to outperform peers.

As always, thank you for your continued support.

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