

# EMPIRE LIFE DIVIDEND GROWTH FUND UPDATE

June 30, 2023



**DOUG COOPER, CFA**  
Senior Portfolio Manager

The objective of this commentary is to review the approach of the Empire Life Dividend Growth Fund and how the fund is positioned today, including any major changes over the past year.

## A focus on free cash flow per share growth reinforces the Fund's defensive qualities

The majority of the fund's holdings share one important metric: strong and consistent free cash flow per share growth<sup>1</sup>. A long track record of this metric is important. Even more important is understanding the attributes of a company, and the industry that it operates in, that can continue to support strong and consistent free cash flow per share growth over the long-run (ideally ahead of market expectations). These attributes include a good management team, a sustainable competitive advantage, defensive/growing end-markets, and a strong balance sheet. Companies with these attributes often generate material shareholder value over time from high levels of consistent free cash flow and dividend growth. The fund's disciplined approach to valuation strives to buy (sell) these companies at an appropriate discount (premium) to our fair value estimate which can further enhance risk-adjusted returns.

From a portfolio construction standpoint, the fund pulls from a list of high-quality Canadian and global companies that in many cases our team has followed for years. These are companies that we have a deep knowledge of (including the industries they operate in) so when valuations reach an attractive level, the stock can be quickly added to the portfolio if it makes sense from a portfolio positioning standpoint. Macroeconomic analysis plays a role in determining how defensive the portfolio will be from a sector/regional exposure and individual stock perspective. However, the fund will not make material top down or "macro calls", so it can be expected that the economic sensitivity, and therefore the sector/regional exposures of the portfolio, will not deviate much from the fund's Canadian dividend peers.

<sup>1</sup> Strong and consistent book value per share growth would be applicable to financials/banks.

## Fund positioning

As of June 30, 2023, financials comprised the largest sector weight of the fund at 31.2%. Compared to the S&P/TSX Composite Index, financials were slightly overweight but conservatively positioned with holdings including Intact Financial Corp and U.S.-based Progressive Corp. Compared to the fund's dividend peers, it was likely underweight financials. Canadian banks made up the largest part of financials (about two-thirds), although slightly underweight the S&P/TSX Composite Index and probably underweight compared to peers.

Canadian bank valuations are at levels that appear to reflect a mild recession and related to this, a modest deterioration of credit. Loan reserves appear to be at sufficient levels as do the average capital levels of the Canadian banks. However, for the banks' October 2024 fiscal year, consensus earnings appear high which suggests downside risk as credit trends worsen and loan growth slows (in particular for those banks with less capital) so we anticipate bank stocks will remain range bound for the foreseeable future.

Energy was the next biggest weight at 15.1%, notably lower than the S&P/TSX Composite Index weight of 16.6%. The fund's energy weight was probably roughly in line with its Canadian dividend fund peers, but skewed more towards pipeline and royalty companies where there is much better visibility of free cash flow per share growth. As an example, producers like Suncor, Canadian Natural Resources, and Cenovus made up approximately one-third of the fund's energy exposure, with the balance consisting mostly of Enbridge and TC Energy with smaller weights in Keyera and Prairie Sky Royalty.

Taking a longer-term view, the fund has a constructive view on oil prices due to some very attractive supply-side dynamics. However, over the short-term, the fund is taking a more defensive position in energy on a somewhat cautious demand outlook. Also, the fund is seeing a lot of value in the utility like pipelines including TC Energy and Enbridge. Both of these companies have very good visibility on earnings and dividend growth in the mid-single digit and low single digit range, respectively. In addition, dividends for both companies are yielding roughly 7%. The fund will consider taking a less conservative position in energy in times of extreme negative sentiment (which does not appear to be the case today).

Consistent with the fund's defensive positioning, it held an overweight position versus the S&P/TSX Composite Index (and likely versus peers) in consumer staples and health care at 8.1% and 3.6%, respectively. Further contributing to the overall defensiveness of the fund, compared to the S&P/TSX Composite Index, it was underweight industrials and materials and overweight utilities and telecommunications.

From a regional perspective, Canadian equities made up 83.5% of the fund while U.S. and International equities made up 9.7% and 5.3% of the fund respectively. Compared to the fund's Canadian dividend peers, it was likely slightly overweight both U.S. and International equities.

## Changes to the Fund

The fund's sector weights have remained relatively unchanged over the past year. On the margin, Financials and Energy are slightly lower, Utilities, Consumer Staples and Real Estate are slightly higher. From a regional perspective, Canadian and U.S. equity exposures have not changed much, although the fund's International equity exposure has decreased slightly.

## Performance: Contributors and Detractors

For the one-year period ending June 30, 2023, stocks that had the greatest positive contribution to fund performance included Stella Jones, Restaurant Brands International, TJX Companies, Alimentation Couch Tard, and Merck & Co. Collectively, these stocks drove 560 basis points of positive fund performance. The top five negative contributors to fund performance included TC Energy Corp, Bank of Nova Scotia, Nutrien, Suncor Energy Inc., and Emera Inc. Collectively, these stocks detracted 158 basis points from fund performance.

From a sector standpoint, top positive contributors to fund performance included Consumer Discretionary, Consumer Staples, and Industrials. No single sector detracted from fund performance.

## Key reasons to consider investing in the Fund:

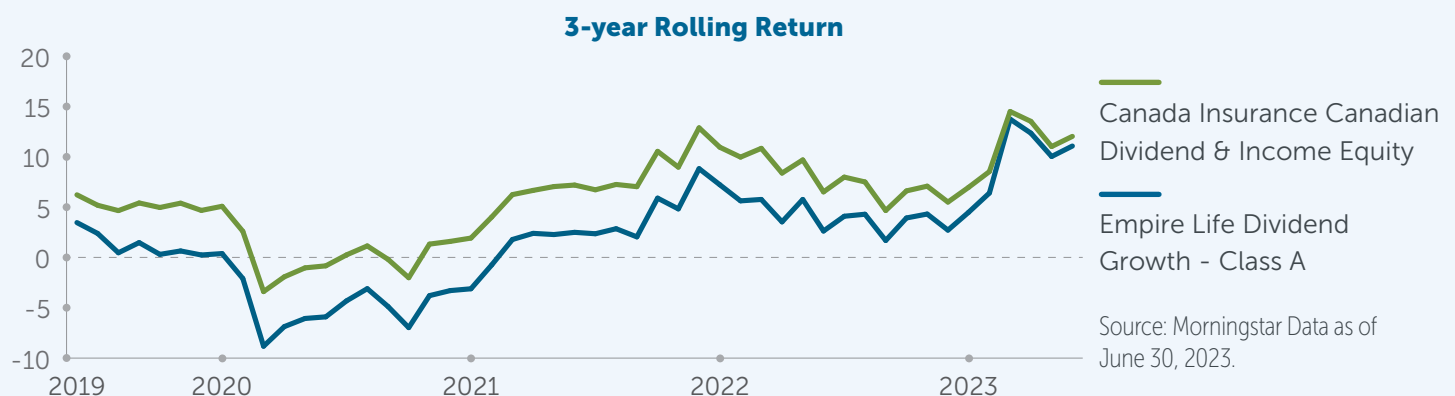
**Gain conservative exposure to equities in what continues to be an uncertain economic backdrop:** The Empire Life Dividend Growth Fund can be expected to exhibit much less volatility than the broader equity markets, while still offering attractive absolute returns in strong equity markets.

**An attractive dividend yield reinforced by strong and resilient dividend and earnings growth:** Today, (based on Bloomberg consensus) the fund's twelve month forward dividend yield is 3.8% and the portfolio's dividends are expected to grow by nearly 7% in 2023, roughly in line with the portfolio's expected earnings growth. Moreover, as a result of the highly defensive nature of most of the fund's holdings, there is very good visibility on this level of anticipated dividend and earnings growth. While yields on cash (or risk-free investments) are high today at about 5%, inflation is also high resulting in an underwhelming real return in the 1-2% range. With the Empire Life Dividend Growth Fund, we believe the prospect of a more attractive real return exists for income seeking investors due to 1) the fund's dividends, that have shown to be very secure in most macro environments<sup>2</sup> and that historically have demonstrated attractive growth<sup>3</sup> 2) the earnings growth of the fund's holdings and 3) the fund's approach to investing in a company at a discount to its fair value which results in the potential for higher returns from a valuation tailwind.

**Dividends are a significant contributor to total returns:** As an example, over the past ten years dividends accounted for over 40% of the S&P/TSX Composite Index's total compound annual growth return (CAGR) of 8.4%. Given the material contribution of dividends to total returns, dividend funds should be an important consideration when constructing a portfolio.

**Top quartile performance:** As an example, as of June 30, 2023, the Empire Life Dividend Growth Fund outperformed 96% of its peers over the past year with a return of 8.32%, almost double the 4.28% return of its peer group. The fund's three-year CAGR (as of June 30, 2023) of 11.07% was strong on an absolute basis and only slightly below the 11.98% CAGR of its peer group.

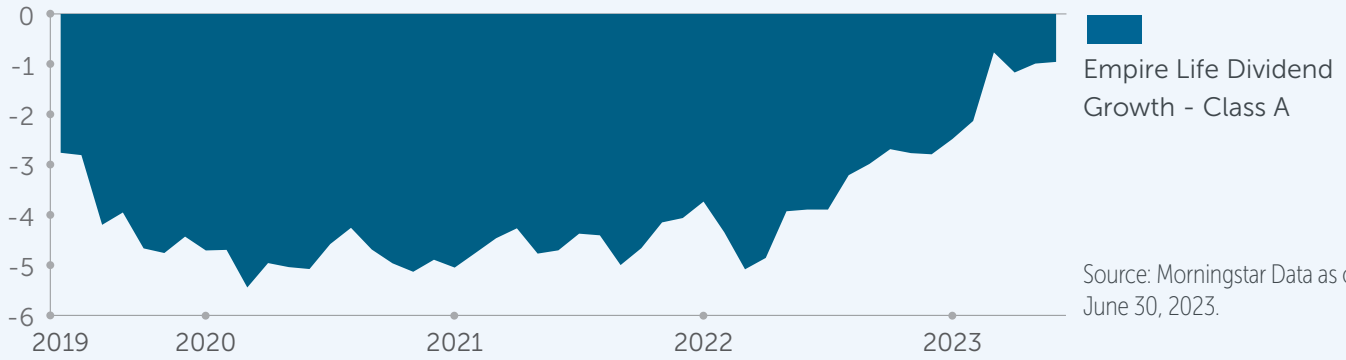
Performance and risk metrics have also improved for the **Empire Life Dividend Growth Fund** over the past four years and are now tracking more in line with its peers.



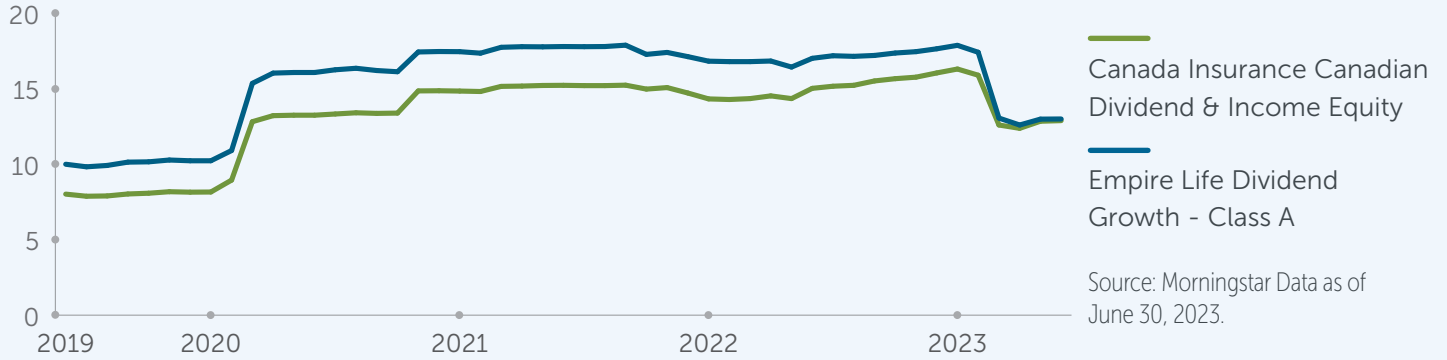
<sup>2</sup> For example, during the COVID-19 pandemic only six of the fund's current holdings cut or temporarily discontinued dividends (source: Bloomberg)

<sup>3</sup> The fund's holdings increased dividends on average at a CAGR of 7.6% over the past five years (source: Bloomberg)

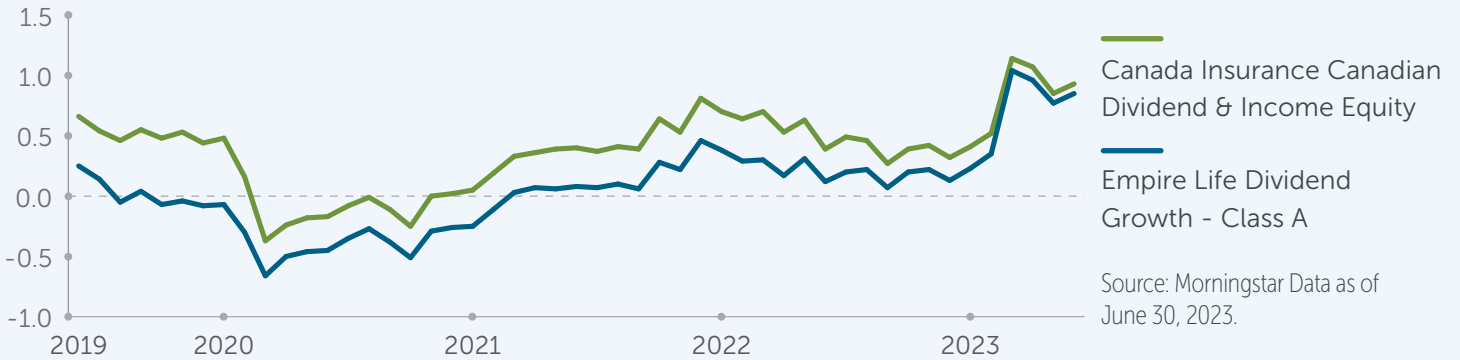
### 3-year Rolling Return Relative to Canada Insurance Canadian Dividend & Income Equity



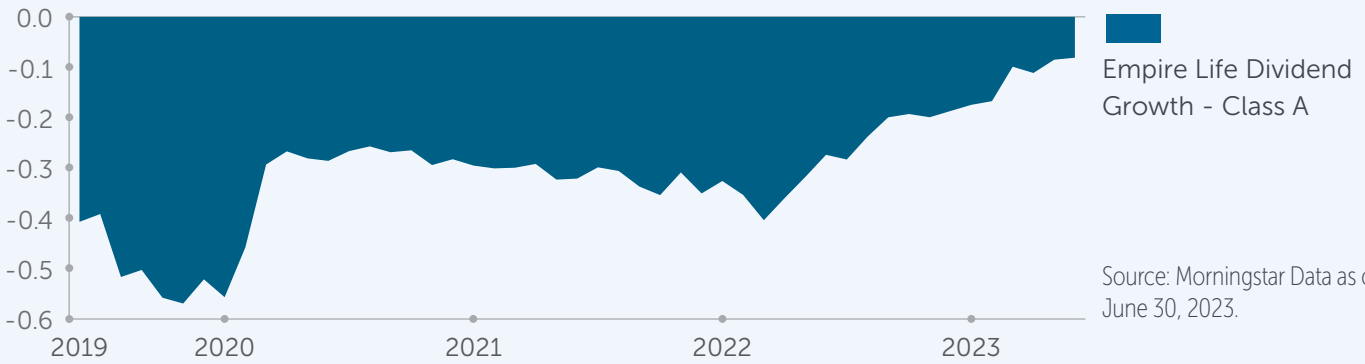
### 3-year Rolling Standard Deviation



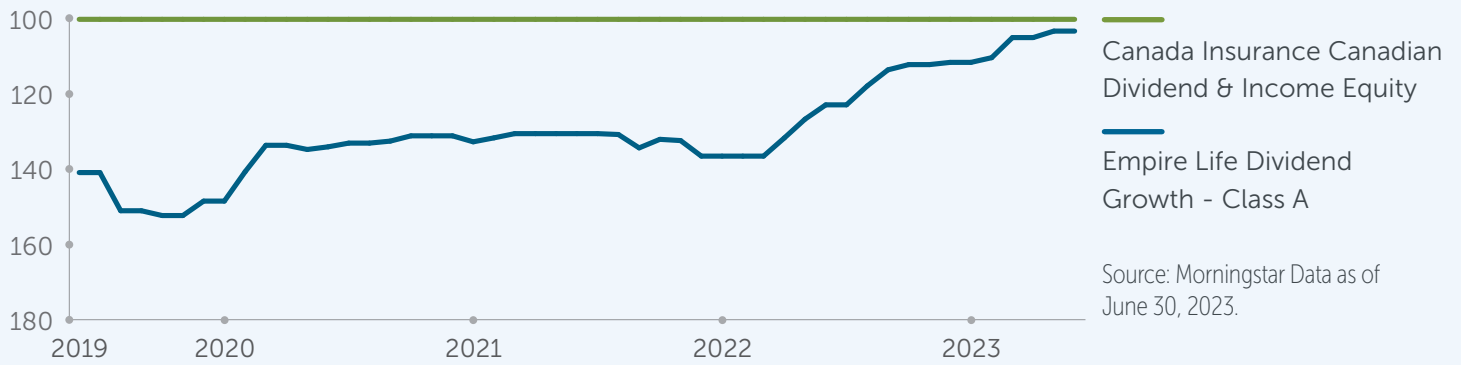
### 3-year Rolling Sharpe Ratio



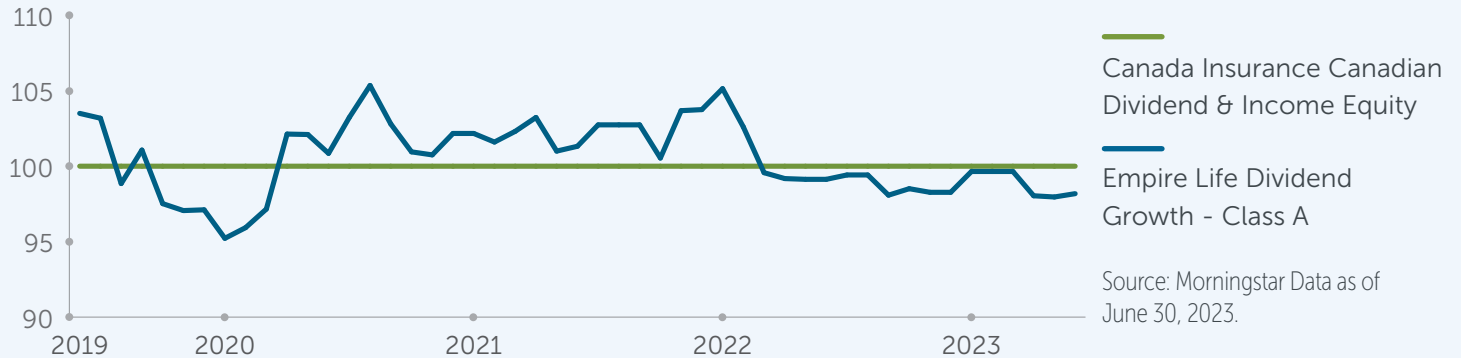
### 3-year Rolling Sharpe Ratio Relative to Canada Insurance Canadian Dividend & Income Equity



### 3-year Rolling Down Capture Ratio

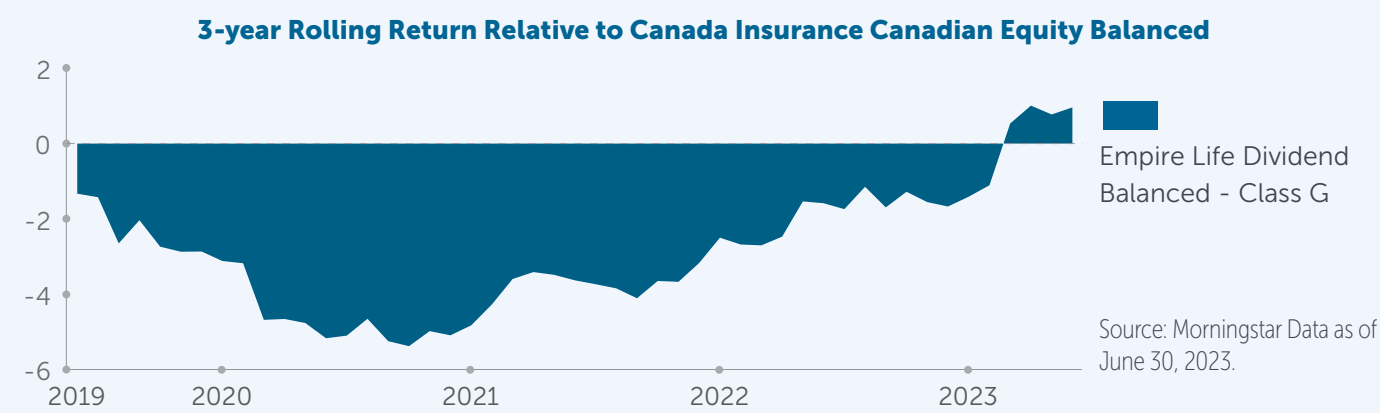
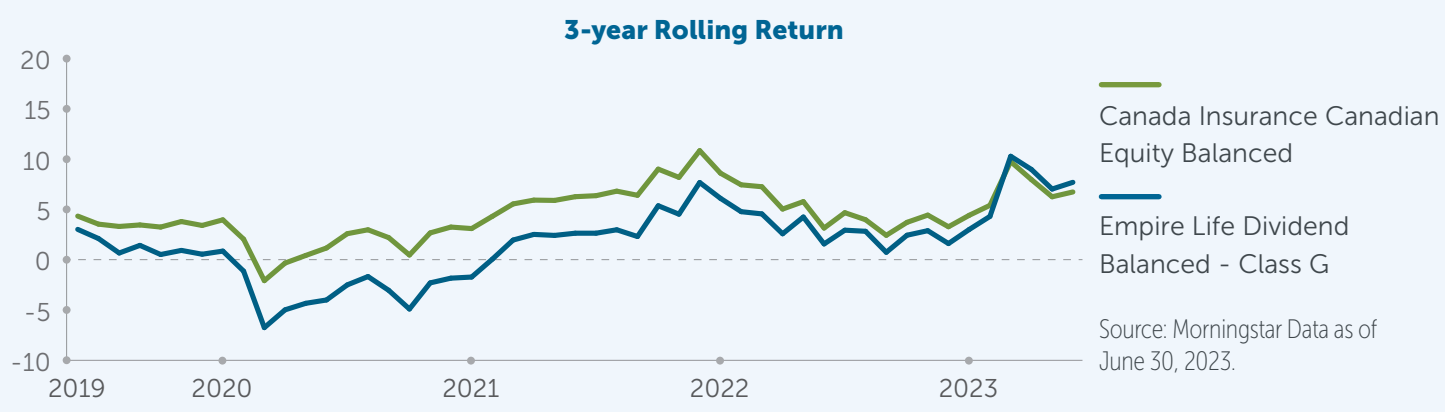


### 3-year Rolling Up Capture Ratio

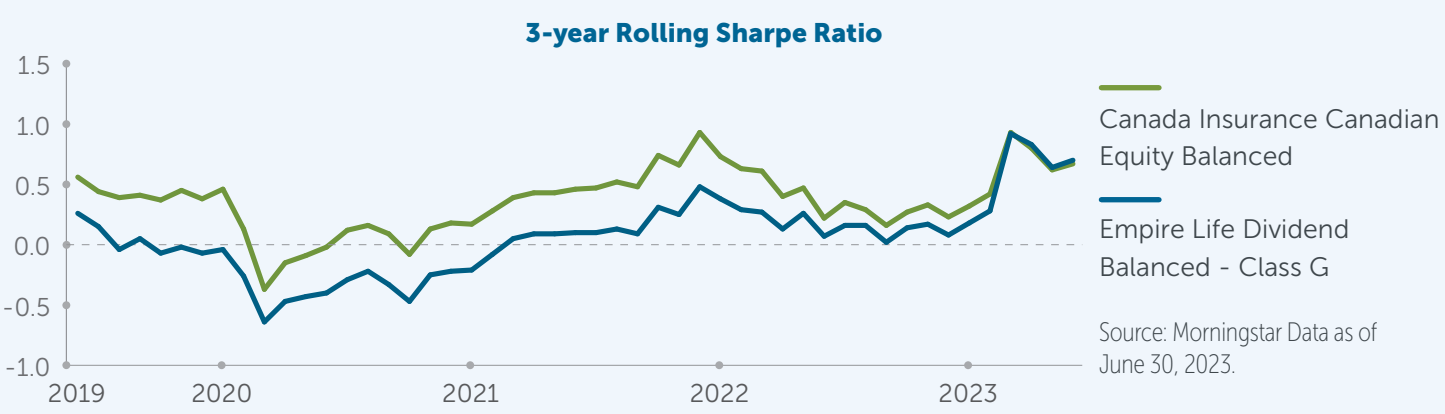


Performance and risk metrics of the **Empire Life Dividend Balanced Fund** have improved substantially over the past four years. As a reminder, 80% of the Empire Life Dividend Balanced Fund is invested in the Empire Life Dividend Growth Fund.

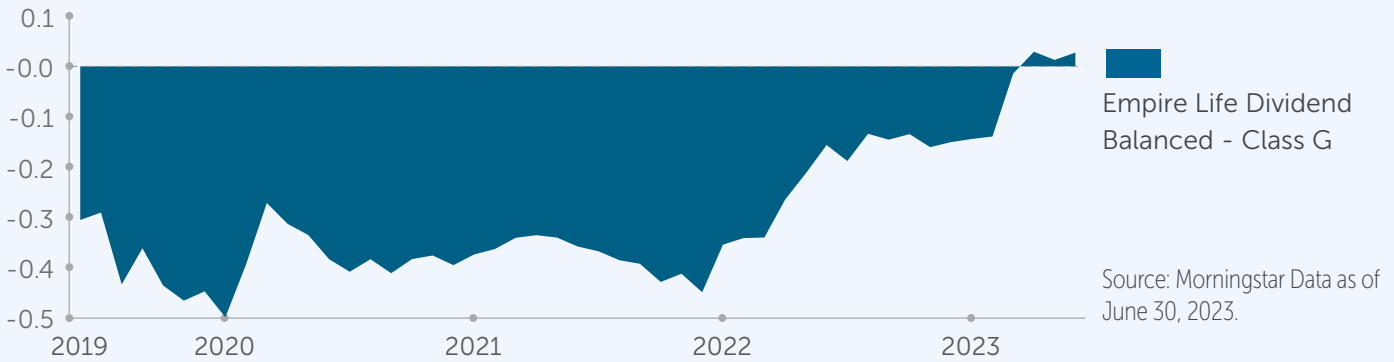
For the three-year period ending June 30, 2023, the Empire Life Dividend Balanced Fund was ranked 1st quartile, outperforming 88% of its peers:



The fund's three-year Sharpe Ratio (risk adjusted returns) has steadily improved and is now outperforming its peer group:



### 3-year Rolling Sharpe Ratio Relative to Canada Insurance Canadian Equity Balanced

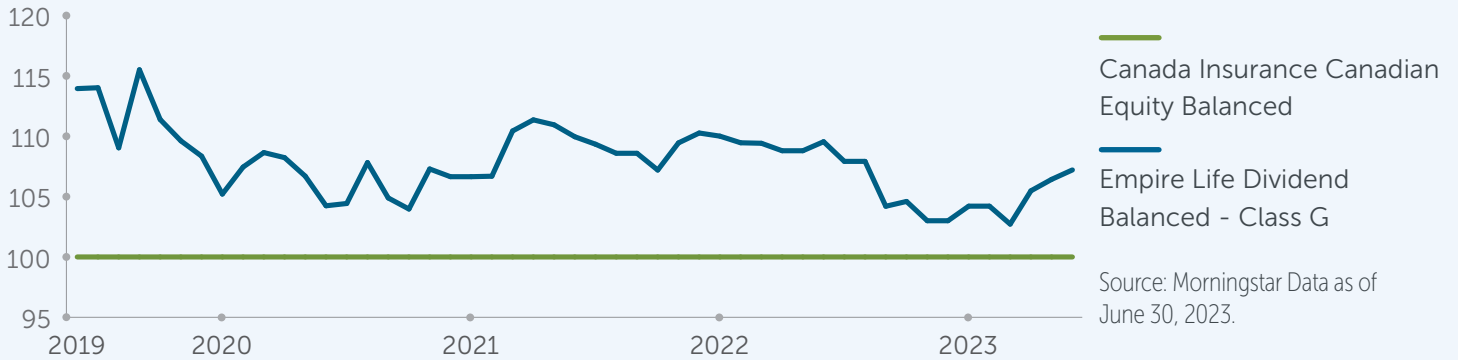


Compared to peers, the three year down capture ratio has improved significantly while maintaining a favourable up capture ratio:

### 3-year Rolling Down Capture Ratio



### 3-year Rolling Up Capture Ratio



## Performance

	3-month	1-year	3-year	5-year	10-year
Empire Life Dividend Growth - Class A	1.36	8.32	11.07	2.17	4.65
Canadian Dividend & Income Equity Category Return	0.46	4.28	11.98	5.28	6.12
Over/Under Performance	0.90	4.04	-0.91	-3.11	-1.47

	3-month	1-year	3-year	5-year	10-year
Empire Life Dividend Balanced - Class G	0.92	6.74	7.69	1.65	3.85
Canadian Equity Balanced Category Return	0.99	8.26	6.69	3.93	4.90
Over/Under Performance	-0.07	-1.52	1.00	-2.28	-1.05

 Contact your advisor to discuss how Dividend Growth can fit into your portfolio, or visit [empire.ca](http://empire.ca) for more information.

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259 King Street East, Kingston, ON K7L 3A8 • 1 877 548-1881 • [info@empire.ca](mailto:info@empire.ca) • [empire.ca](http://empire.ca)

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