



Ryan Crowther CFA
Director,
Portfolio Manager



Izabel Flis CFA
Director,
Portfolio Manager

Canadian Dividend Strategy

Key Takeaways

- ▶ Following a surging third quarter, the S&P/TSX Composite Total Return Index added 3.8% in the fourth quarter, reaching an all-time high in December.
- ▶ Trading activity was heightened in the fourth quarter of 2024 as the ongoing strength in equity markets presented several opportunities to trim on strength and prioritize other new and existing positions in the portfolio.
- ▶ During periods of elevated enthusiasm in equity markets, and at times when investors are collectively paying a full price or potentially more growth attributes, a focus on valuation is crucial and arguably more important than at any point in the market cycle.

Market Overview

Following a surging third quarter, the S&P/TSX Composite Total Return Index (TRI) added 3.8% in the fourth quarter, reaching an all-time high on December 6. The S&P/TSX Composite TRI advanced 21.7% for the year — impressive returns for a market experiencing modest earnings growth with headwinds from higher interest rates, yet with strong expectations for double-digit earnings growth in 2025.

The meaningful drop in benchmark 10-year interest rates in Canada and the U.S. last quarter reversed, as yields rose 9.1% and 20.8% in the fourth quarter to finish at 3.23% and 4.57%, respectively. Interest rates continue to sit below their respective 4.24% and 4.99% October 2023 highs. The increase in interest rates, and therefore discount rates, has direct negative implications for the valuation of equities, all else equal. The U.S. Federal Reserve continued its rate-cutting cycle with two 25 basis point decreases in the quarter; however, the outlook for further cuts is murkier with lingering inflation concerns. For the Bank of Canada, a less robust economy relative to the U.S. has contributed to its dovish policy stance, resulting in two 50 basis point rate cuts to finish the year. The Canadian dollar continued to decline against the U.S. dollar, ending the quarter at \$1.438 CDN/USD, further impacted by threats of broad-based tariffs from President-elect Donald Trump's second term.

Performance Overview

The Strategy trailed the S&P/TSX Composite TRI in a quarter unfriendly to income-oriented sectors such as communication

services, utilities and real estate, where we are overweight. Stock selection in the real estate sector was the main detractor, almost all of which was Granite REIT, whose units have lagged due to increased industrial real estate supply in North America affecting industry fundamentals. Although construction completions are expected to taper, excess supply has led Granite to lower its portfolio occupancy expectations. Despite a decline in rent growth, Granite's mark-to-market rent growth on renewals offers room for earnings growth. Long-term benefits from e-commerce, distribution and Granite's strong balance sheet continue to screen as attractive.

Communication services was the worst-performing sector in the index, meanwhile, with our overweight a detractor due to double-digit declines for holdings BCE and TELUS. We increased our position in BCE following the company's announcement of its acquisition of Zipl Fiber, a U.S. fiber operator in the Pacific Northwest. The proposed transaction came as a surprise both strategically and in terms of timing, appearing to contradict the company's efforts to strengthen its balance sheet through the sale of non-core assets (Maples Leaf Sports and Entertainment). We acknowledge that this shift in capital allocation strategy, including the announced dividend reinvestment program, raises questions about the company's future priorities between growth and free cash flow. However, the market reaction overlooks BCE's steady cash flow generation and ability to leverage alternative financing options to protect returns and alleviate the risk of dilution. That said, incremental developments with BCE will be closely monitored.

Other absolute detractors included Canadian National Railway and Canadian Pacific Kansas City, which continue to deal with the effects of labor issues and new concerns over the potential pending impacts of tariffs on cross border trade.

Bright spots for performance included an underweight to the underperforming materials sector as well as stock selection there, where three of four holdings made positive gains in a sector that declined -4.7%.

Portfolio Positioning

Trading activity was heightened in the fourth quarter as the ongoing strength in equity markets presented several opportunities to trim on strength and prioritize other new and existing positions in the portfolio.

In the energy sector, we added to our position in Pembina Pipelines (PPL), a leading Canadian midstream and pipeline company, operating the largest Western Canada Sedimentary Basin network of gathering and processing, NGL pipelines, storage, fractionation and marketing assets, connecting the Montney/Duverney formations to end markets. PPL's integrated network exemplifies a strong moat, and with assets located in the most productive plays, PPL should be

able to increase the utilization of existing assets, organically outgrow the basin and profitably add capacity through smaller, higher-return investments.

In utilities, we took advantage of share price strength to trim our position in Brookfield Renewables (BEPC) as AI-related enthusiasm and surging demand for data centers drove share prices higher for BEPC and many of its peers. Renewable generation and other energy and data-related infrastructure businesses remain well-positioned to benefit from secular tailwinds supportive of global decarbonization and digitization efforts and we maintain appropriate exposure.

In industrials we initiated a new position in heavy equipment dealer Toromont (TIH). We have long appreciated the business and management's track record of driving-double digit earnings growth over many years and through business cycles, through strong operating performance and shareholder-friendly and thoughtful capital allocation. The company also maintains a pristine balance sheet, and we expect its dividend to grow over time alongside free cash flow.

Outlook

The portfolio continues to emphasize dividends, but as always, our focus is on risk-adjusted total return and not merely "income." During periods of elevated enthusiasm in equity markets, and at times when investors are collectively paying a full price for potentially more growth attributes, a focus on valuation is crucial and arguably more important than at any point in the market cycle. We continue to place a high value on secular growth in our evaluation of businesses, but we are not willing to forego total return for the portfolio by overpaying for securities. Our approach, if properly executed, should lead to a portfolio with an attractive but not overly ambitious dividend yield, and should optimize the risk-adjusted return potential of the strategy.

Portfolio Highlights

The ClearBridge Canadian Dividend Strategy underperformed its S&P/TSX Composite TRI benchmark during the fourth quarter. On an absolute basis, the Strategy generated gains across three of nine sectors in which it was invested (out of 11 sectors total). The top-contributing sectors were financials and energy, while real estate, communication services and utilities were the main detractors.

On a relative basis, stock selection and sector allocation detracted. In particular, stock selection in and an overweight allocation to real estate and utilities, stock selection and an underweight to IT, stock selection in industrials and financials and a communication services overweight detracted. Conversely, stock selection in and an underweight to materials proved beneficial.

In terms of individual securities, the top contributors to absolute returns were Bank of Montreal, Enbridge, Royal Bank of Canada, Bank of Nova Scotia and Arc Resources. The main absolute detractors were Granite Real Estate Investment Trust, Brookfield Renewable, BCE, Toronto-Dominion Bank and Telus.

In addition to portfolio activity outlined above, during the quarter we sold out of Choice Properties REIT in the real estate sector.

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