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Canadian Dividend Strategy

Key Takeaways

- ▶ Equity market returns accelerated throughout the first quarter with particular strength in March helping to propel the S&P/TSX Composite TRI to new all-time highs.
- ▶ Volatility in oil and natural gas commodities was mirrored by volatility in the stocks, providing trading opportunities.
- ▶ We believe valuations of some equities are embedding uncomfortably high expectations for profitability in the year to come, and our bottom-up process and fundamental approach to valuation positions us well in this environment.

Market Overview

The S&P/TSX Composite Total Return Index returned 6.6% in the first quarter, building on the 11.8% return for full-year 2023. Equity market returns accelerated throughout the first quarter with particular strength in March helping to propel the S&P/TSX Composite TRI to new all-time highs.

Benchmark 10-year interest rates in Canada and the U.S. ended the first quarter higher at 3.47% and 4.21%, respectively. Although below their October 2023 highs, around the time of the Fed's dovish pivot, 10-year rates steadily inched back up in the first quarter of 2024 and remain at levels not seen since the Global Financial Crisis (GFC). Consensus expectations for Fed rate cuts in 2024 have tempered meaningfully, and we remain mindful of the potential impact on equities from a structurally higher interest rate environment. With average market interest rates proximal to earnings yields in the equity market, cost of capital implications and competing investment alternatives for stocks will remain critical considerations as investors continue to re-acclimatize to a non-ZIRP (zero interest rate policy) and non-TINA (there is no alternative) world.

The first quarter advance in Canadian equities was broad-based, with nine out of 11 sectors posting positive returns. Health care, energy and industrials were the top performers and the only three sectors to outperform the benchmark. Defensive/non-cyclical and interest-rate-sensitive sectors — utilities, communication services and real estate — were the biggest laggards. In energy, rising oil prices drove strength in exploration and production as well as integrated energy companies, notwithstanding a weak natural gas market. In materials, gold bullion advanced 7.0% in the quarter to reach a new all-time high for the commodity.

Higher interest rates put pressure across the entire renewable energy space in 2023, leaving some shares well below our estimate of intrinsic value.

Portfolio Positioning

Crude oil and natural gas prices moved in opposite directions in the first quarter, with oil strengthening on continued OPEC production restrictions and gas weakening on warmer than expected winter temperatures. Volatility in the commodities was mirrored by volatility in the stocks, providing trading opportunities. Generally rising stock prices in the sector provided an opportunity to trim positions in ARC Resources, Canadian Natural Resources, Parkland Corporation and Topaz Energy. We increased our weight in Tourmaline Oil on relative weakness early in the quarter, and also established a new position in Parex Resources. Parex is a Canadian company with oil and gas assets in Colombia; it is a key partner of the Colombian state oil company Ecopetrol, holding a number of production sharing agreements. Parex has an established track record of generating excess free cash flow, from which it has pursued a multiyear share buyback program and, more recently, instituted an attractive dividend. Our opportunity to purchase an initial position came after the company updated its three-year business plan. Parex had built a number of contingencies into its production forecast, and the accompanying analyst forecast revisions put some pressure on the share price. We see the company as trading at an attractive discount to its intrinsic value, with its clean balance sheet (positive net cash balance) mitigating investment risk.

We also established a position in Brookfield Renewable Corporation (BEPC) in the quarter. BEPC is the common share equivalent investment to the limited partnership units of Brookfield Renewable Partners LP (BEP), a leading global developer, owner and operator of renewable power generation facilities, and a past holding in the portfolio. The advent of higher interest rates put pressure across the entire renewable energy space in 2023, and we saw the shares trade well below our estimate of intrinsic value. Through its sponsor, Brookfield Asset Management, BEP/BEPC has access to large pools of private capital it can deploy in attractive co-investment opportunities.

The last wholesale change was the elimination of Brookfield Corporation (BN) early in the quarter. After initially underperforming Brookfield Asset Management upon being spun out, the shares appreciated significantly beginning in the latter part of 2023, and we sold the last of our holdings in January.

Outlook

Last year's optimistic equity market sentiment continued uninterrupted into 2024, with the theme of AI commanding attention and driving in some cases tangible growth, in others speculative enthusiasm, into an array of securities, many of which arguably already carried very high valuations as they exited 2023. In our view, current market conditions reflect investors becoming less mindful of downside risk, and the equity market appears to discount an ideal scenario that includes not only rate cuts, but also continued economic

growth and solid corporate earnings. We believe valuations of some equities are embedding uncomfortably high expectations for profitability in the year to come. Our bottom-up process and fundamental approach to valuation positions us well in this environment. We will continue to consistently adhere to our framework and to seek out opportunities for the portfolio as they present themselves.

Although the portfolio emphasizes dividends, our approach remains oriented around risk-adjusted total return and not merely income. Valuation is the primary driver of our portfolio decision making, but embedded in our assessment of valuation are core attributes we seek, such as secular growth, profitability and durability of the business, quality managements with diligent approaches to capital allocation, and capital structures that align with the predictability of cash flows and cyclical exposures. We use this approach to design a portfolio with an attractive but not overly ambitious dividend yield, and one that seeks to optimize the risk-adjusted return potential of the Strategy.

Portfolio Highlights

The ClearBridge Canadian Dividend Strategy* underperformed its S&P/TSX Composite Total Return Index benchmark during the first quarter. On an absolute basis, the Strategy generated gains across six of the nine sectors in which it was invested (out of 11 sectors total). The primary contributors to total return came from the energy, financials and industrials sectors while the communications services sector was the main detractor.

On a relative basis, overall sector allocation and security selection detracted from performance. In particular, overweight allocations to the poorly performing communication services and utilities sectors as well as stock selection in information technology (one stock held) weighed on results. On the positive side, and underweight allocation and selection in the materials sector contributed to performance.

On an individual stock basis, the largest contributors to absolute returns were from Canadian Pacific Kansas City, Agnico Eagle Mines, CCL Industries, TMX Group and Bank of Nova Scotia. Holdings that detracted most from absolute returns were BCE, Telus, Open Text, Toronto-Dominion Bank and Allied Properties REIT. Although we own Canadian Natural Resources, being underweight this strong performer with a large benchmark weight stock also detracted.

*Formerly known as the Franklin Bissett Canadian Dividend Strategy.

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