FRANKLIN TEMPLETON | ClearBridge

Canadian Dividend Strategy

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Key Takeaways

- Equity markets advanced strongly in the second quarter, supported by improved risk appetite, resilient corporate earnings expectations and continued enthusiasm around AI and related capital spending.
- Weaker commodity prices created a mixed backdrop for Canadian equities, where financials and select cyclicals performed well, while energy and materials were more challenged.
- We are seeking to participate in important growth themes where appropriate, while maintaining the Strategy's core emphasis on income, dividend growth, diversification and valuation discipline.

Market Overview

Equity markets advanced strongly in the second quarter, supported by improved risk appetite, resilient corporate earnings expectations and continued enthusiasm around AI and related capital spending. Canadian equities extended their positive run, with the S&P/TSX Composite Total Return Index rising 7.0% in the quarter, its eighth consecutive quarterly gain.

The quarter was not without crosscurrents. Oil prices remained volatile as geopolitical uncertainty around Iran and the Strait of Hormuz gave way to renewed concerns about supply, inventories and demand. Gold also weakened from earlier highs as a stronger U.S. dollar and higher real-rate expectations weighed on the metal. These moves created a mixed backdrop for Canadian equities, where financials and select cyclicals performed well, while energy and materials were more challenged.

From a portfolio perspective, the quarter reinforced the challenge of balancing participation in the market's strongest themes with valuation discipline. While the portfolio had measured exposure to AI infrastructure and related capital-spending beneficiaries, the most speculative areas of the rally were not where we saw the best risk/reward. At the same time, this backdrop created attractive opportunities to add to high-quality businesses that had underperformed due to near-term sentiment, perceived AI disruption risk or cyclical concerns.

Portfolio Positioning

Trading activity remained elevated during the quarter as dispersion across sectors and individual securities created opportunities to recycle capital. Notable transactions included the elimination of Open Text, Granite REIT, EQB and Arc Resources, the establishment of a new position in Cameco and further additions to Thomson Reuters and WSP.

In IT, we exited our long-standing position in cloud software provider Open Text. While the company has historically offered an attractive cash flow and capital return profile, our conviction had moderated. Organic growth has remained insufficient, leverage remains elevated and the company faces a more complex landscape strategically with technology risks that could impact go-forward profitability.

We initiated a small position in Cameco during the quarter after a sharp selloff created an attractive entry point. We have had a more constructive view of the company since its November 2023 acquisition of a 49% interest in Westinghouse, which broadened Cameco's exposure beyond uranium mining and conversion into a more integrated nuclear power platform with strategic relevance across the fuel cycle, reactor technology and nuclear services. The transaction also brought Cameco into a strategic partnership with Brookfield, and that platform has since been further strengthened by a U.S. government partnership aimed at accelerating the deployment of Westinghouse reactor technology. We continue to view Cameco as one of the highest-quality ways to gain exposure to the long-term nuclear power theme, supported by scarce uranium assets, disciplined contracting, Western supply security and growing electricity demand. The position was sized modestly, reflecting both the opportunity and the inherent volatility of uranium-related equities, but it gives us room to build the position further if market volatility moves the valuation more meaningfully in our favor.

Thomson Reuters has been pressured by concerns that AI could disrupt its mission-critical legal and tax workflow assets. We believe that risk is too simplistically discounted. In legal, tax and compliance workflows, accuracy, trust, proprietary content and accountability remain critical, and AI may ultimately expand the value of embedded platforms rather than displace them.

WSP has faced similar concerns around AI and engineering services, as well as broader cyclical pressure. We partially funded these additions by trimming Toromont, where we continue to hold a meaningful position but believe the market is increasingly recognizing optionality tied to data-center-related power demand. By contrast, we believe the market is leaving similar optionality on the table at WSP, particularly following the TRC acquisition, which expands WSP's power and energy capabilities across generation, advisory, energy efficiency, transmission and distribution. We believe WSP's scale, technical expertise, client relationships and exposure to infrastructure, power demand, the energy transition and environmental services remain attractive long-term attributes.

Outlook

We remain constructive on the portfolio's forward setup. Market concentration and AI enthusiasm create risks, but they also create opportunities in overlooked dividend-paying companies with durable cash flows, strong balance sheets and the ability to compound through a range of environments. We are seeking to participate in important growth themes where appropriate, while maintaining the Strategy's core emphasis on income, dividend growth, diversification and valuation discipline.

The current environment favors selectivity. We continue to prefer businesses with resilient free cash flow, pricing power, disciplined capital allocation and the ability to grow dividends over time. Periods of narrow leadership can be challenging for diversified dividend portfolios, but they often create attractive long-term entry points in high-quality businesses.

Portfolio Highlights

The ClearBridge Canadian Dividend Strategy outperformed its S&P/TSX Composite Dividend benchmark during the second quarter. On an absolute basis, the Strategy generated positive contributions across six of nine sectors in which it was invested (of 11 total). The financials sector contributed the most, while materials and communication services were the main detractors.

Relative outperformance was driven by stock selection in the energy and materials sectors along with underweights to those sectors. Stock selection in and an underweight to financials detracted, along with an overweight to communication services.

In terms of individual securities, the top contributors to relative returns were Bank of Montreal and not owning Suncor Energy, Kinross Gold, Barrick Mining and Nutrien. The main relative detractors were Wheaton Precious Metals, Franco-Nevada, WSP, Telus and not owning CIBC.