

# Trust In Dividends

**Raymond James**

**Investing in the New Decade**

John Priestman

*Senior Portfolio Manager, GCLP*



**GUARDIAN CAPITAL LP**

# Agenda

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- **Core Belief: Dividends Matter**
  - Income is as Important as Capital Gains
  - GPS: Growth and Payout Sustainability
- **The Power of Payouts**
  - Historical Perspective
- **Where is the Tax-Advantaged Yield?**
  - Income Trusts Transition Into Corporations
  - REITs and Resources
- **Portfolio Strategy**
  - Effective Selling Disciplines



# Guardian Growth and Income Fund

- Launched in October 1996 as GGOF Monthly High Income Fund
  - Canada's first Income Trust-centric Mutual Fund
  - Revised mandate, effective January 1<sup>st</sup> 2010
  - Monthly distribution reduced from 6¢ to 3.5%
- Managed by Guardian Capital LP
  - Guardian Capital's Equity Income team comprised of four senior portfolio managers
  - No staff turnover since Fund's inception
- Fund has had only one down year in the past ten years
  - **Ten year annualized total return of +13.5%** versus **+5.6%** for S&P/TSX Composite
  - Year-to-date (August 31<sup>st</sup>) return of **8.5%** versus **3.2%** for S&P/TSX Composite

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
<b>BMO Guardian Monthly High Income Classic</b>	22.3%	21.9%	9.9%	31.1%	25.4%	23.7%	2.3%	6.8%	-27.4%	34.3%

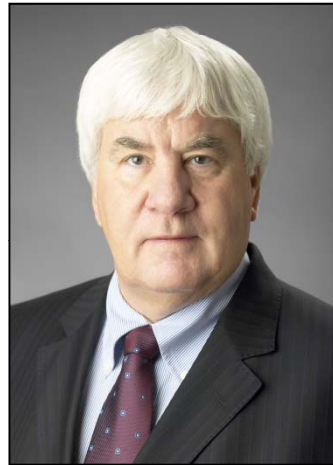


# Guardian Capital's Equity Income Team



Kevin Hall, *CFA*  
*Senior Portfolio Manager*

16 yrs. Industry Experience



John Priestman  
*Managing Director*

40 yrs. Industry Experience



Ted Macklin  
*Managing Director*

26 yrs. Industry Experience



Michele Robitaille, *CA, CFA, CBV*  
*Senior Portfolio Manager*

16 yrs. Industry Experience

**Supported By Two Analysts And A Full Time Trader**



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# Equity Income Approach: GPS

- **Growth**

- Dividend growth is the single biggest factor that drives long term equity returns
- Corporate dividend policy is a powerful signaling mechanism regarding its prospective operating performance

- **Payout Sustainability**

- Canadian dividend paying equities consistently outperform
- Investors reward the quality of a dividend payout, not just quantity
- Companies must have a competitive advantage to sustain dividend payouts
  
- Most share buybacks are typically ill-timed and unproductive
  
- Dividend payments were severely stress tested in 2008-09
- Economic and earning cycles now support accelerating dividend growth



# Traditional Fundamental Process

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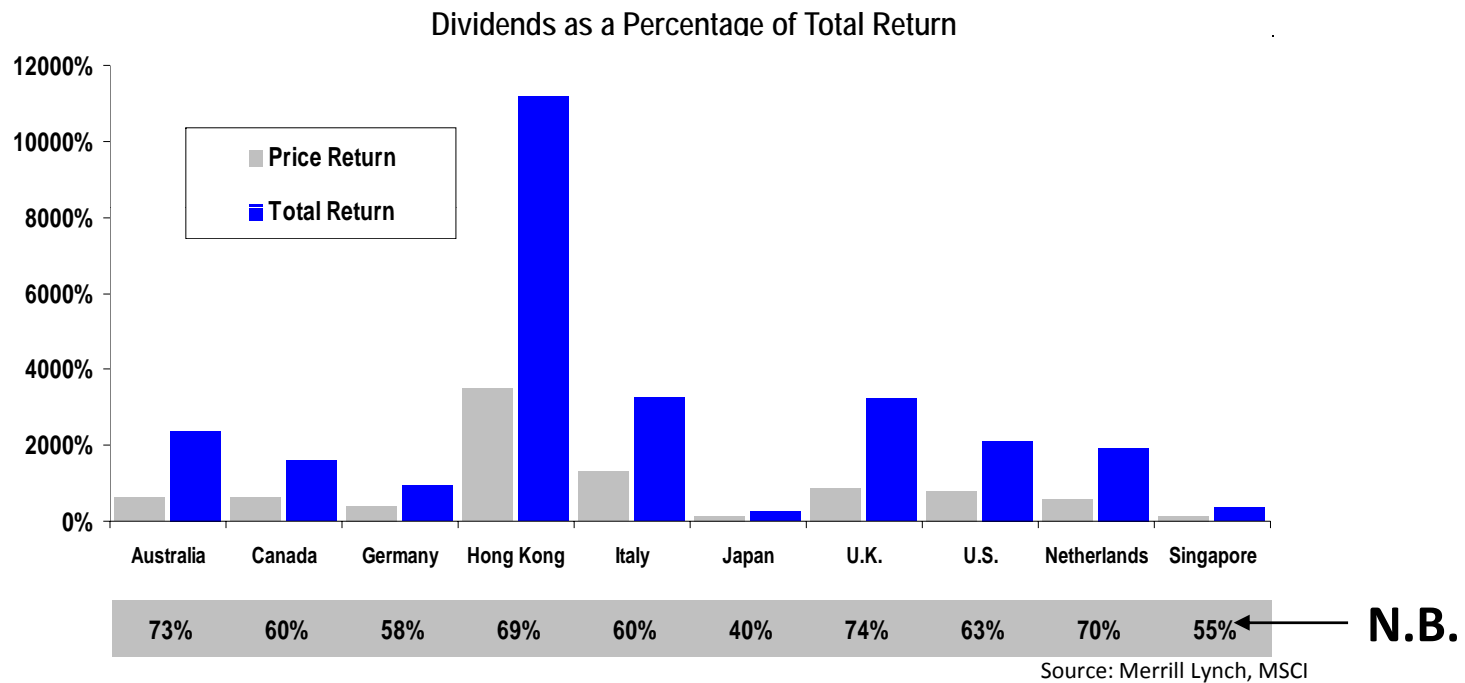
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Growth		Payout		Profitability		Valuation	
<ul style="list-style-type: none"> <li>• Dividend Growth 5 years</li> <li>• Dividend Growth 3 years</li> <li>• Revenue Growth</li> <li>• Earn Per Share Growth</li> <li>• Est. EPS</li> <li>• EPS Revisions</li> <li>• Cash Flow Growth</li> </ul>		<ul style="list-style-type: none"> <li>• Dividend Yield</li> <li>• FCF Payout</li> <li>• CFO Payout</li> <li>• CFO / EPS Divergence</li> <li>• Payout Volatility</li> <li>• Payout Distribution</li> </ul>		<ul style="list-style-type: none"> <li>• Pricing Power</li> <li>• ROE</li> <li>• Margins                             <ul style="list-style-type: none"> <li>• EBITDA</li> <li>• Gross</li> <li>• Net Profit</li> <li>• Operating</li> </ul> </li> </ul>		<ul style="list-style-type: none"> <li>• Price / Book</li> <li>• Price / Sales</li> <li>• P / E / G</li> <li>• Price / Cash Flow</li> <li>• Price / Earnings</li> <li>• P / NAV</li> <li>• Mean Reversion</li> </ul>	
Financials		Management					
<ul style="list-style-type: none"> <li>• Debt Level</li> <li>• Interest Coverage</li> <li>• Debt / EBITDA</li> <li>• Debt / Equity</li> </ul>		<ul style="list-style-type: none"> <li>• Track Record</li> <li>• Alignment</li> <li>• Governance</li> <li>• Competitive Positioning</li> </ul>					



# Dividends Matter: Income is as Important as Capital Gains

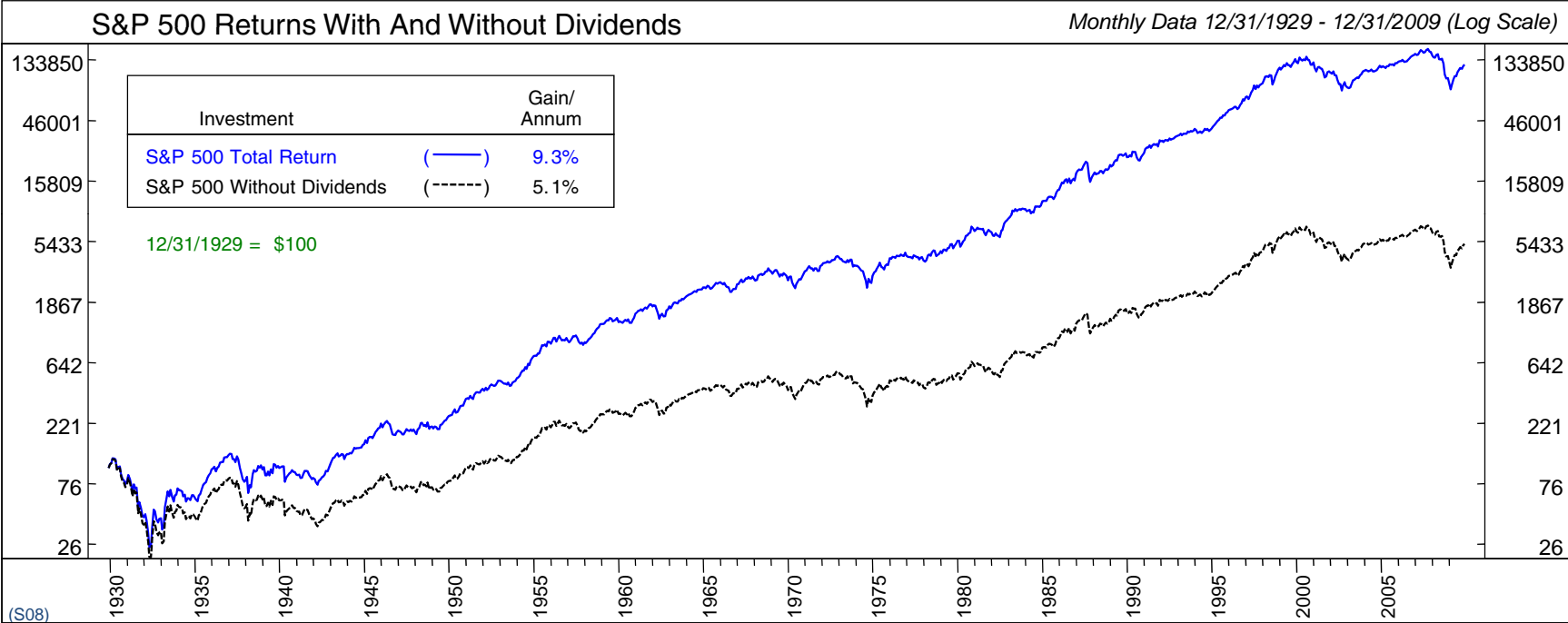
- Dividends have been a larger and more reliable contributor than price appreciation over the past 30 years.



**Dividend Yield Has Accounted For Nearly Two-Thirds of  
Total Long-Term Return in Global Markets.**



# Dividend-Paying American Equities



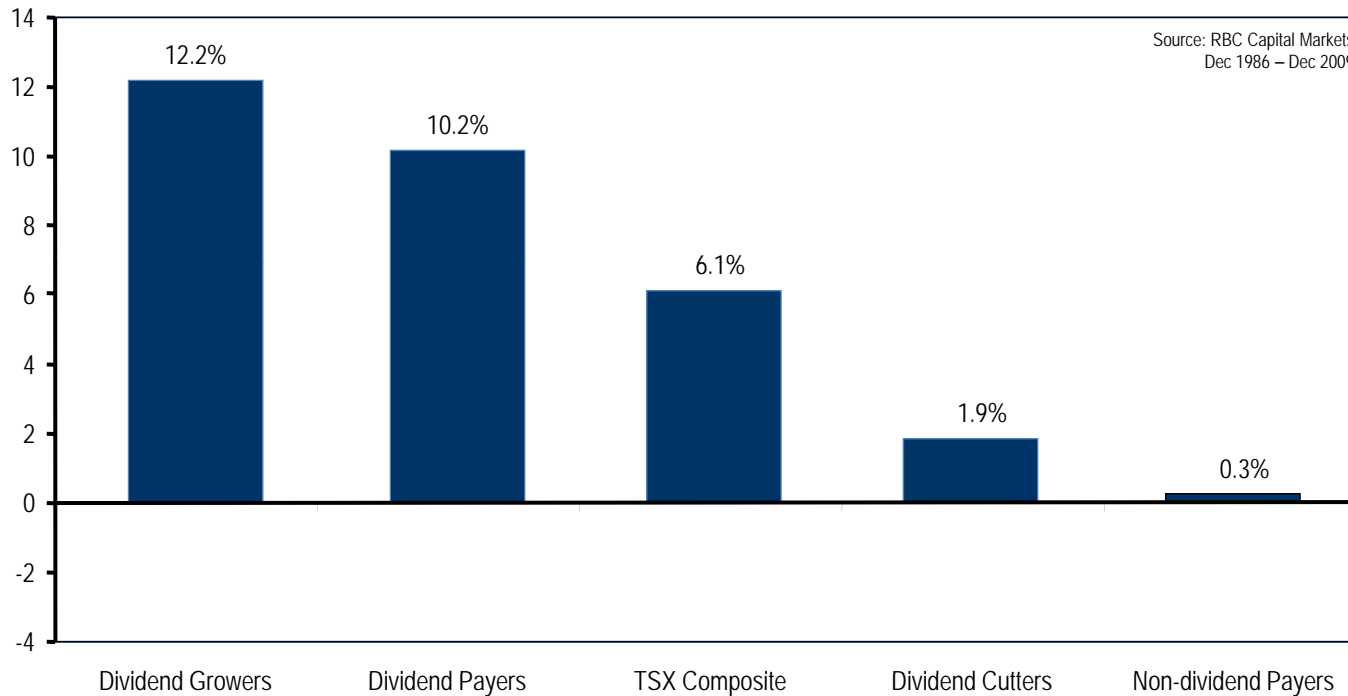
Source: Ned Davis Research  
As at December 31, 2009

**High Correlation of Dividend Increases and Prospective Earnings Momentum**



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# Dividend-Paying Canadian Equities Consistently Outperform



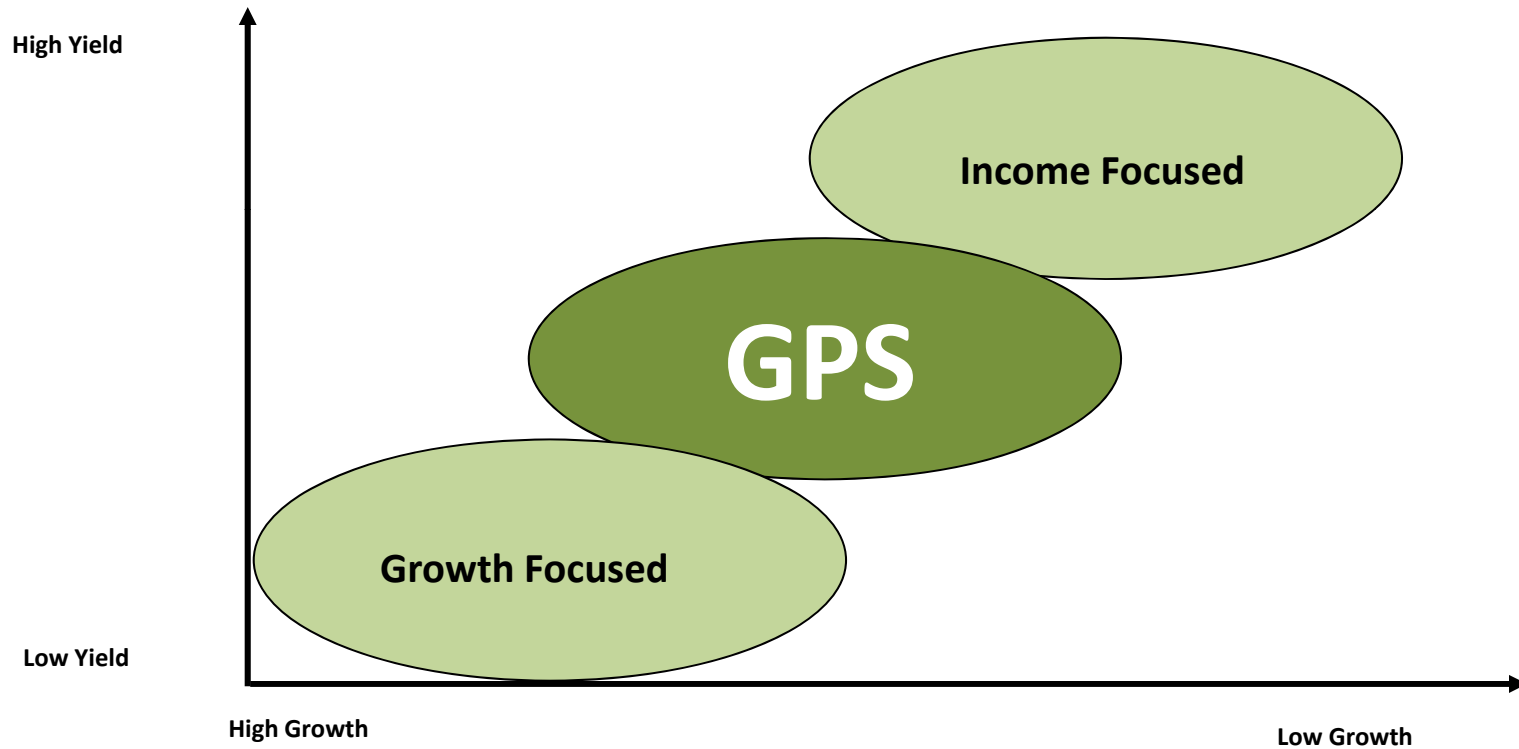
**An Important Component of Total Return and Reduced Portfolio Volatility**



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# GPS = Total Return

## Risk Spectrum



**Blending of REITs, Dividend Payers and Dividend Growth Stocks**



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# Big Crescendo Finish For Trusts?

- **Unlikely that trusts will match their spectacular historical returns.** However, in a very challenging environment **maintaining a high yielding core of quality Trusts** (REITs and Resources) with generous upfront yields seem appropriate.
- Income Trusts remain on the radar screens of predators as conversion strategies are announced and **M&A activity continues.** Since 2007, **72 transactions** have averaged a premium price of **26%**. LBO's driven by public to private trust arbitrage.
- Sadly, many institutions and fund companies (domestic and foreign) have missed the diversification benefits of trust ownership during the past decade. We **expect institutional and foreign ownership to increase steadily as trusts convert back to corps** and become an **integrated** component of the S&P/TSX Composite Index.

	1 YR	2 YR	3 YR	10 YR
S&P/TSX <u>Income Trust</u> Index	+ 42.2 %	+ 2.5 %	+ 3.9 %	+ 16.1 %
S&P/TSX <u>Composite</u> Index	+ 35.1	-4.9	-3.3	+ 5.6
<b>Trust Outperformance</b>	+ 7.1	+ 7.4	+ 7.2	+ 10.5



# Increasing Institutional Demand for Yield

- We expect S&P will roll out a new “**Dividend Index**” by year-end replacing the S&P Income Trust Index and the Dividend Aristocrats Index. The S&P/TSX REIT Index will be retained.
- We expect that this new “**Dividend Index**” will become an important benchmark for institutional investors, indexers, ETFs etc.
- Our **guess** is that stocks and Income Trusts now included in the S&P/TSX Composite Index with a minimum yield of **2.75% - 3.00%** will qualify for the new index. In addition, a 25% sector cap and 5% individual cap would probably be instigated. Such an index could produce a dividend yield of about **5%**
- The Index will have a meaningful representation of Reits and Income Trusts as they convert to corporations.



# Why Dividend Strategies are Important Now

## 1) Demographic Demand

- Tax-effective income increasingly important for retired Boomers
- Exploit dividend tax credit

## 2) Demise of Defined Benefit Plans

- Best ever retirement plan ending

## 3) Less Competition from Fixed Income

- Low historic rates means a million is not enough

## 4) Range Bound Equity Market

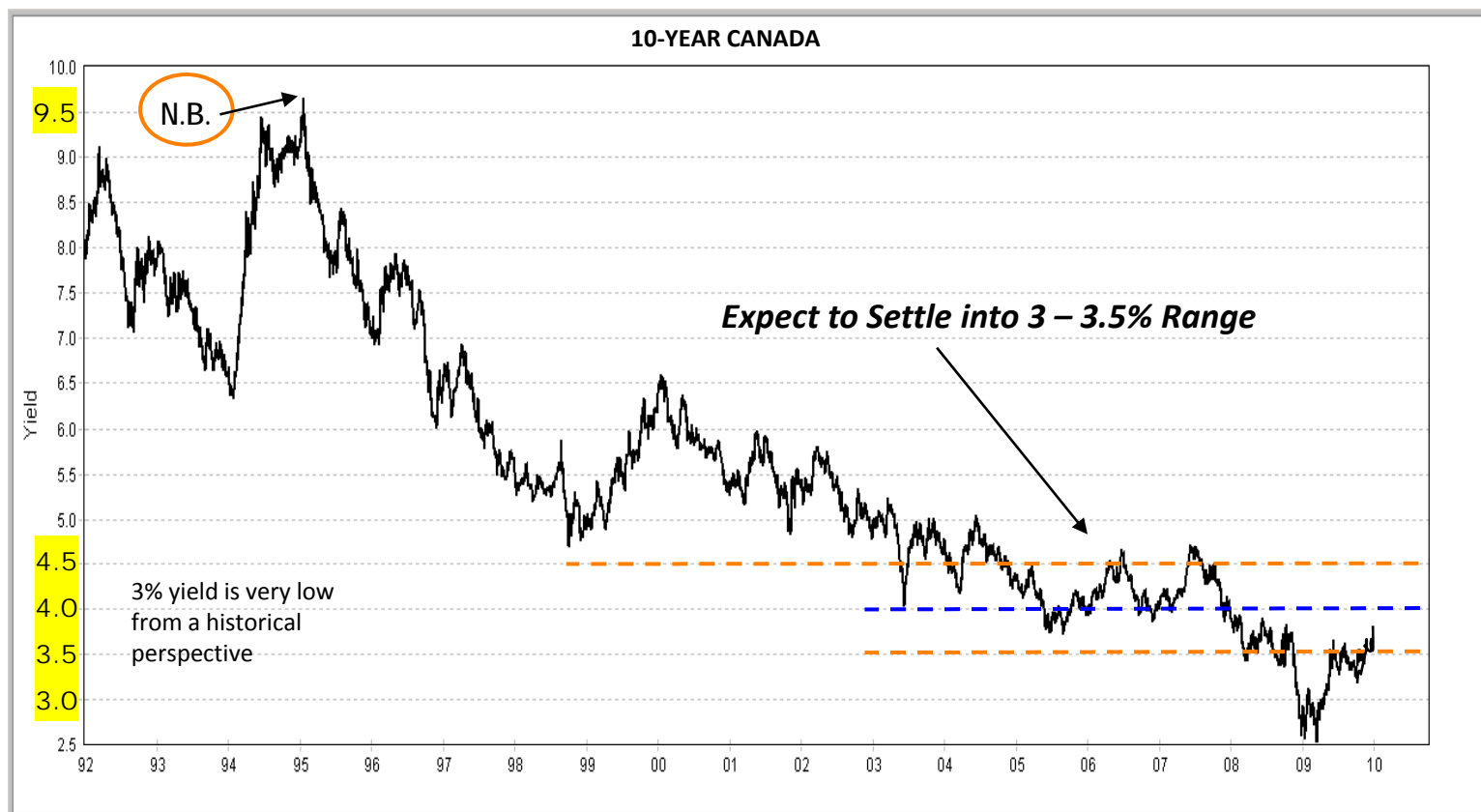
- Working through Structural Headwinds.
- Income becomes Increasing Component of Total Return

## 5) Concentration of TSX Dividend Payouts

- Only Three of Ten TSX Equity Sectors Yield More Than 2.0%
- High Payout Ratios Slowing Dividend Momentum



# Low Risk, Low Return for Yield Investors



**Economy Healing Slowly. Expect Rekindled Global Growth, Mild Inflation and Increased Supply Will Nudge Rates Higher in 2011-12**



# Why the Fed Will Raise Rates Slowly in 2010-11

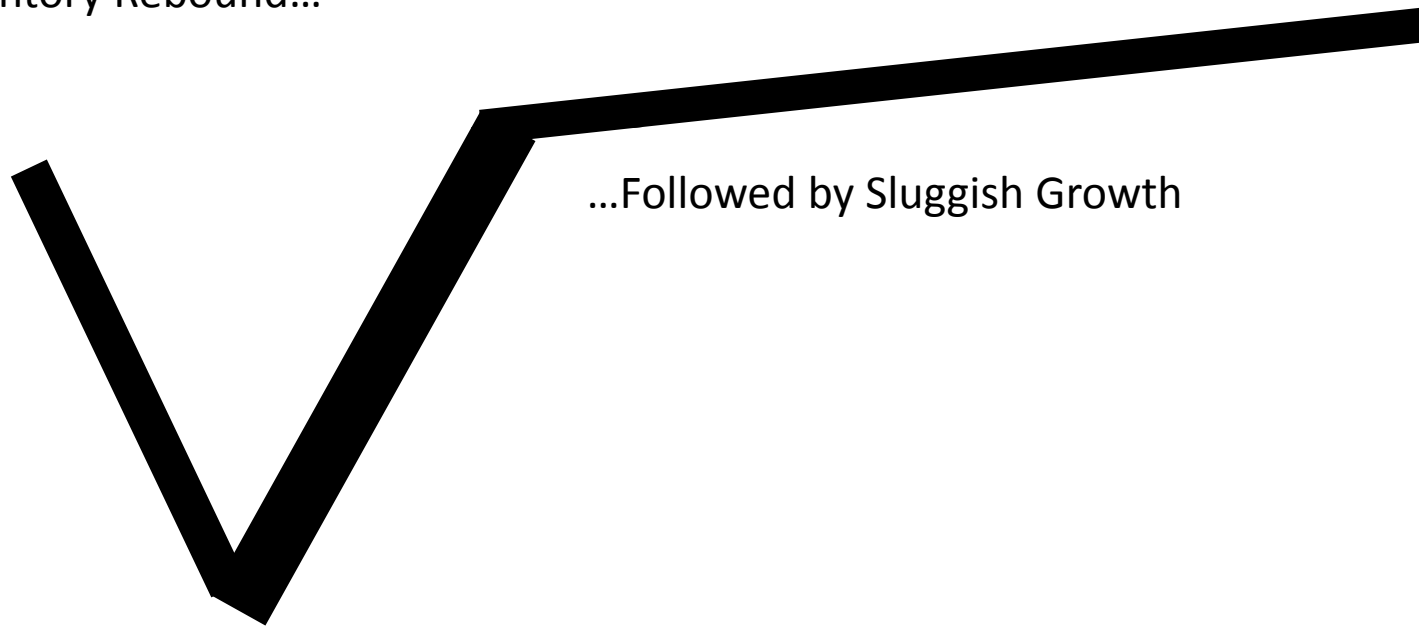
- Bernanke has vowed not to repeat mistakes of 1930s (deflation) and 1970s (inflation)
- Economy healing slowly
- Fear of “double dip”
- Inflation is not a near-term problem
- Elevated unemployment rate.
- Consumer deleveraging
- Huge deficits addressed via taxation and spending cuts
- Banking system health not fully restored
- Housing recovery is very fragile
- **Post-2010, expect subdued economic growth due to “structural headwinds”**



# The Summer Market Correction

Square-root-shaped recovery remains on track:

An Inventory Rebound...



...Followed by Sluggish Growth

Is Discounting much Slower Growth in 2011-12



# Three Drivers of Equity Returns

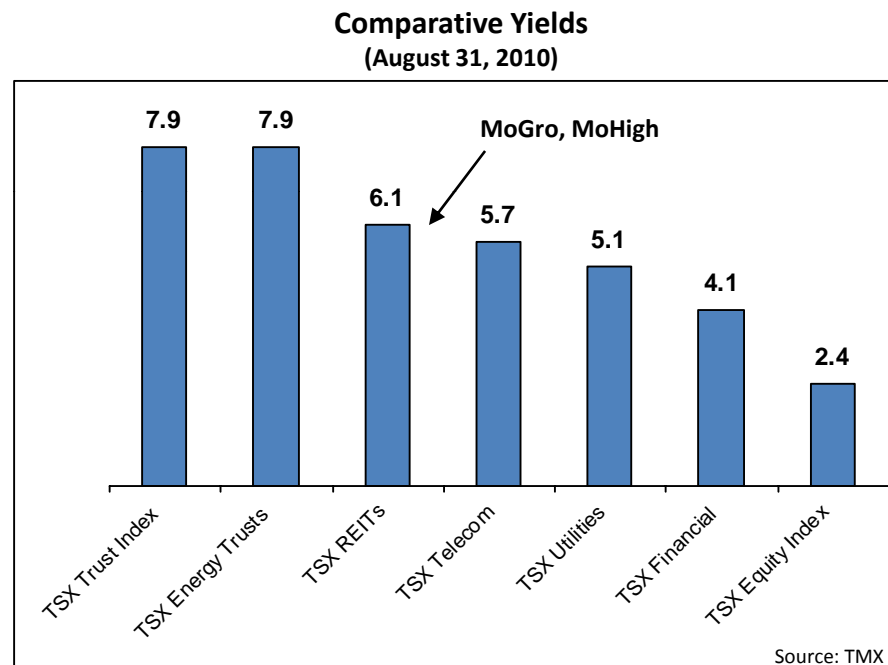
- **Increasing Multiples**
  - Multiple expansion was the dominant contributor to strong equity returns in 1980s and 1990s as interest rates fell from **16% to 4%**
  - Inverse correlation of interest rates and stock price/earnings multiples
  - Flat to higher interest rates mean **flat to lower price/earnings multiples**
- **Increasing Earnings**
  - Equities are a good hedge against inflation and capture productivity gains better than any other asset class
  - But corporate **profits will track slower economic growth** over the next few years
- **Upfront Yield**
  - Dividend income becoming more important component total return than capital gains
  - Expect GPS style will generate about 5% of upfront yield.

**Dividends are the Cake, not the Icing on the Cake.**



# Highest Yielding Sectors In S&P/TSX Composite

- Best Trusts yield between 6-8%, **with moderate capital appreciation potential.**



**Income Trusts Will Become an Important New Source of  
Dividend Paying Canadian Equities**



## Question?

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Should income-oriented investors abandon the highest-yielding, best-performing asset class in Canada when it is about to become 35% more tax effective?



## SIFT's Impact on Stock Selection

1. A distribution **cut of 29% is neutral** on an after-tax basis due to the dividend tax credit.
2. Receiving a dividend identical to a trust distribution produces a **34% increase in after-tax income.**

**Two key considerations in Guardian's  
post-2006 stock selection process**



# Portfolio Strategy: The Three “Rs”

- **Real Estate Investment Trusts: Maintaining 25-30% weighting**

- Exempted from SIFT Tax
- Best income vehicles in Canada
- Tax friendly high yielding sustainable distributions

- **Resources: Maintaining 35-40% weighting**

- Tax pools defer/minimize taxation
- Energy Trusts emerging as a new sector: **Mid Cap dividend paying E&P’s**
- Will provide yield, some growth, strong management and financials.
- Exploration and development upside in major legacy and resource plays in Canada

- **“Retainers”:** 15-20% weighting – **Mostly pipeline/midstream**

- Trusts that will **maintain** their high yielding payouts despite becoming taxable
- High distribution yields become very tax friendly dividends. After tax **income improved by about 35%**.

- **Dividend Growth Stocks**

- Enhance diversification, quality, liquidity, capital growth and future income
- Replacing Business Trusts

Core of Monthly  
High Income Fund  
Retained



**Income Generation is Predictable, Sustainable  
and Tax Advantaged**



# Dodging The SIFT Bullet

10 REITs	<b>Exempt from SIFT tax</b> AP, BEI, CAR, CSH, CUF, EXE, HR, PMI, PMZ, REF, REI
9 Dividend Growth Stocks	<b>Already paying Corporate tax:</b> Altagas, Brookfield Properties, CNQ, Crescent Point, Encana, Finning, Goldcorp, Mullen, Shaw Comm.
5 Energy Trusts	ARC, Bonavista, Canadian Oil Sands, Enerplus, Vermilion. <b>Tax impact deferred by tax pools.</b>
4 “Retainers”	Capital Power, Fort Chicago, Keyera, Just Energy. <b>Income beneficiaries of dividend tax credit.</b>
1 Stapled Unit	Labrador Iron Ore Royalty Corp.
<b>29</b>	

Guardian Unitholders Should Not Be Concerned With Trust Taxation



# Portfolio Concentration: High Quality Large Caps

**As at August 31<sup>st</sup>, 2010**

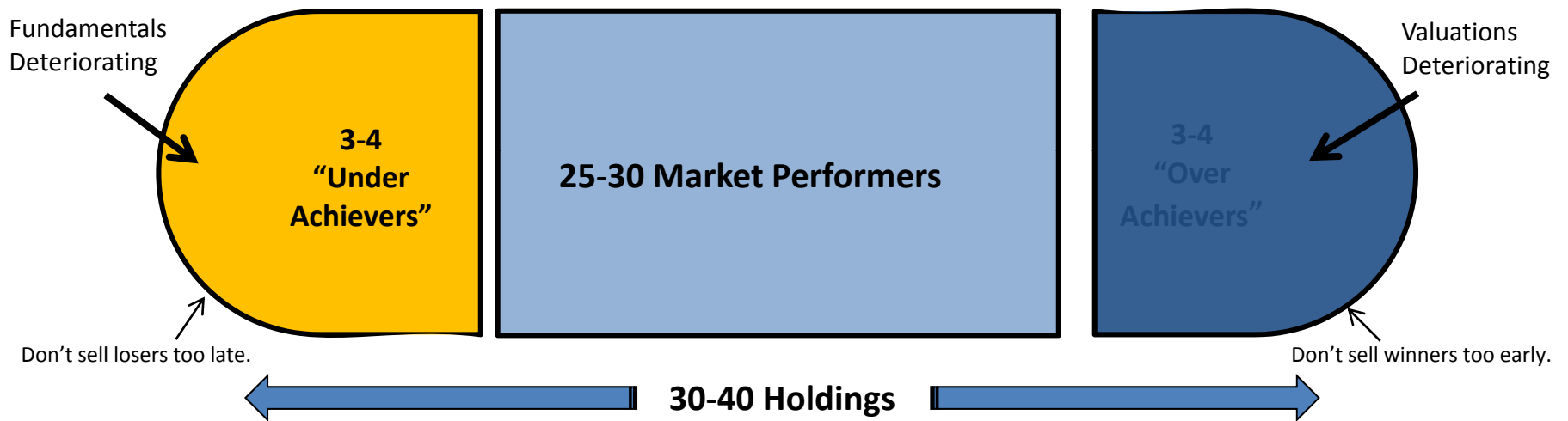
"R&R"	Bonavista	4.5%	CAP REIT	3.0%
	Canadian Natural	4.5%	Brookfield Properties	3.0%
	Canadian Oil Sands	4.5%	Chartwell	3.0%
	Crescent Point	4.5%	CREIT	3.0%
	H&R Reit	4.5%	Enerplus	3.0%
	Labrador Iron Ore	4.5%	Extencicare	3.0%
	Vermilion Energy	4.5%	Finning International	3.0%
			Goldcorp Inc	3.0%
	ARC Energy	4.0%	Primaris	3.0%
	Capital Power	4.0%	Riocan	3.0%
	Cominar	4.0%		
	Keyera	4.0%	Encana	2.5%
	Mullen Transport	4.0%	Just Energy	2.0%
	Altagas	3.5%		
	Boardwalk	3.5%		
Fort Chicago	3.5%			
Shaw Communications	3.5%	Cash	3.5%	

**Top 10 Holdings About 45% of Fund**  
**Top 15 Usually About 60% of Fund**



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# Effective Sell Decisions Preserve Profits and Limit Losses



**Portfolio Management Process Triggered by Selling Discipline.  
Emphasize Early Identification of "Under Achievers"**



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# REITs are the PS in GPS

- REITs exempted from SIFT Tax
- Will become only “Flow Through” vehicles in Canada
- Remain Very Tax Friendly

N.B: Tax Deferred Income

June 30, 2010	PRE-TAX YIELD	EST. TAX TREATMENT			CAPITAL GAIN
		TAX DEF	DIVIDEND	OTHER	
<b>Financials</b>					
Boardwalk Equities	4.5%	60%	0%	40%	0%
Brookfield Properties	3.7%	16%	9%	75%	0%
Canadian Apartment REIT	7.2%	100%	0%	0%	0%
Canadian REIT	5.1%	0%	0%	70%	30%
Chartwell REIT	7.5%	100%	0%	0%	0%
Cominar REIT	7.8%	100%	0%	0%	0%
Extendicare REIT	9.8%	70%	30%	0%	0%
H&R REIT	4.2%	0%	0%	78%	22%
Primaris REIT	7.0%	77%	0%	22%	1%
RIOCAN REIT	7.2%	63%	0%	36%	1%

**Total Market Capitalization Only**  
**\$26-27 billion for 29 TSX-listed REITs**



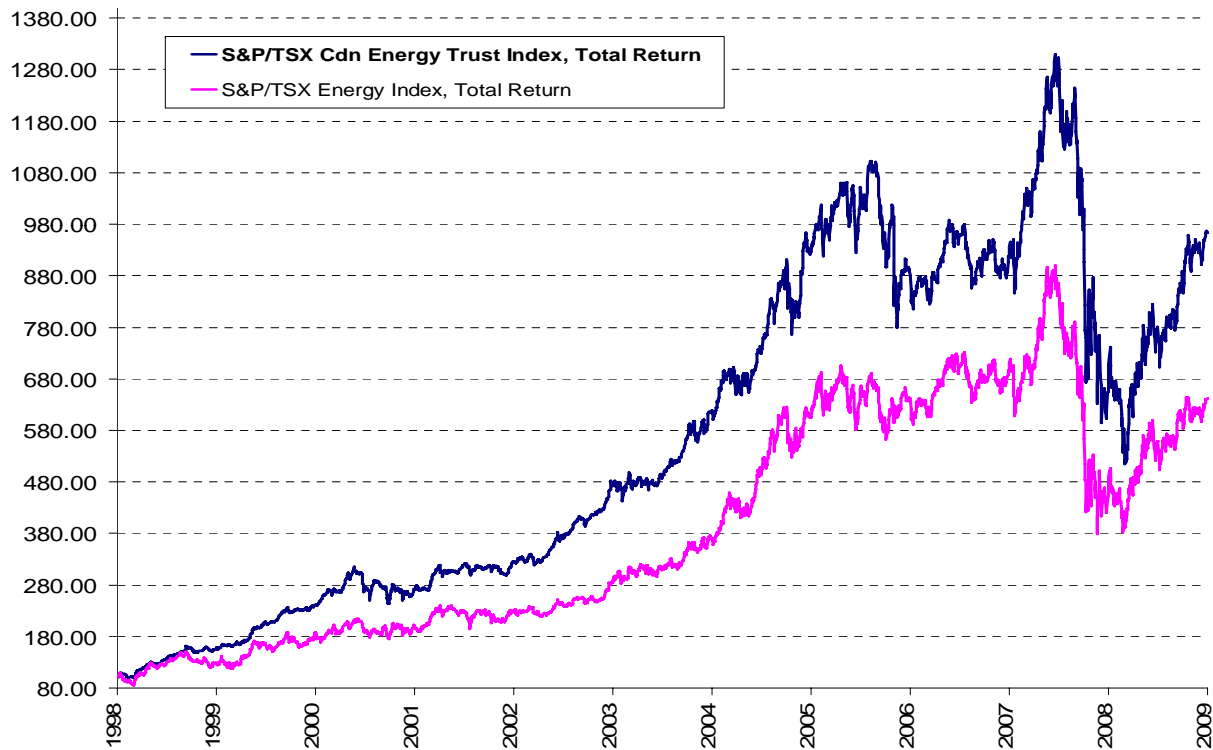
# Mid-Year 2010 Update

- **Fundamentals are Very Good**
  - REIT occupancy firm
  - Flat to 2-3% same property NOI growth
  - Rental rates continue to be higher than in-place rents
- **Capital Debt Markets are Excellent**
  - Beneficiaries of cost and availability of credit
    - Five-year mortgages: 4.25% - 5% (CMHC 3.25 – 3.75%)
    - Ten-year mortgages: 5% - 5.75% (CMHC 4 - 4.75%)
- **Return of IPO Activity**
  - Four new issues: Northwest Healthcare (\$188M), Leasureworld (\$195M), Transglobe (\$247M) and Hamburg Canada (\$160M), BOX pending
- **Lack of Acquisition Opportunities in Canada... but**
  - Big opportunities in USA during 2011-2014 restructuring/refinancing of commercial mortgage debt. Massive conversion of debt into equity.



# Energy Trusts Will Retain Their Core Holding Status

S&P/TSX Cdn Energy Trust Index vs S&P/TSX Energy Index Dec 31, 1998 – Dec 31, 2009



Highly Correlated with S&P/TSX Energy Index but much higher yield.

Source: TD Newcrest

**Ideal Business Model For Income Oriented Investors**



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# Long-Term Fundamental Drivers Are Still in Place

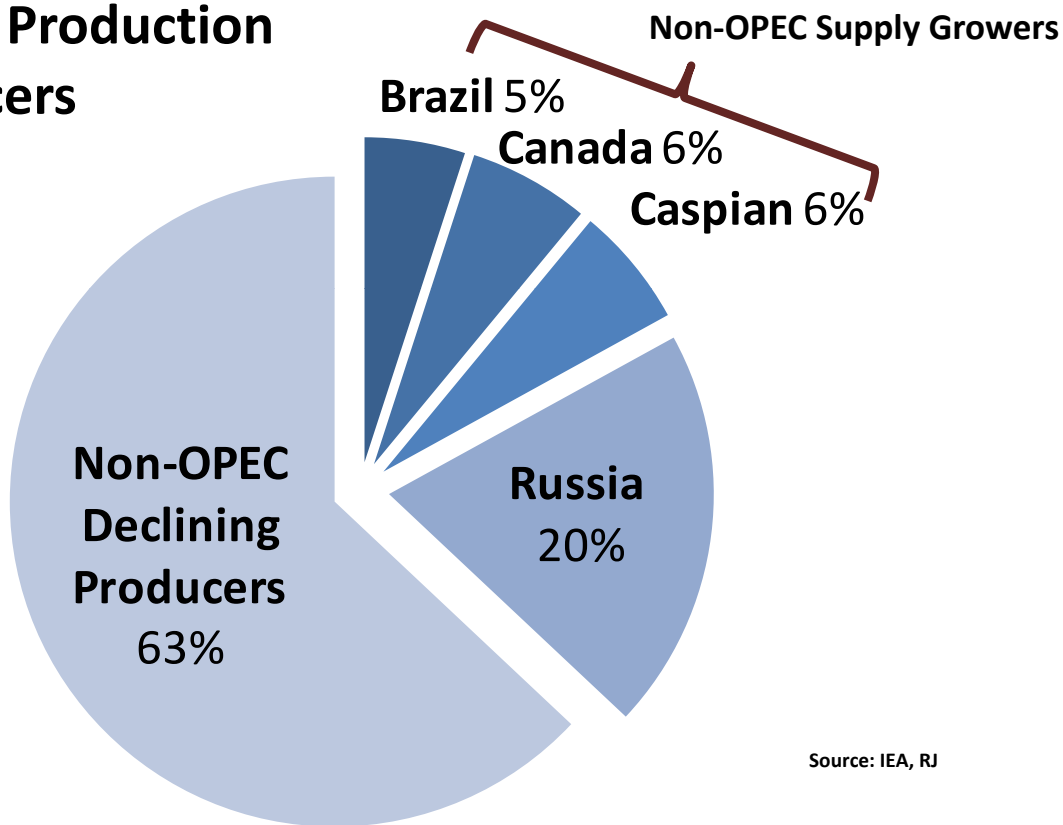
- Global oil demand is recovering
- Excess OPEC capacity will diminish
- Non-OPEC supply is deteriorating
- Market pricing must eventually ration available oil
- How will global printing press impact oil?

**Depletion is Relentless**



# Where will non-OPEC Growth Come From?

**Majority of Non-OPEC Production is from Mature Producers**



Source: IEA, RJ

**Canadian Oil Patch is the Best Global Domain**



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# Emergence of a Mid-Cap, Dividend Paying E&P Sector

- **Taxes Post 2010**

- Modest impact expected from cash taxes post 2010 due to **tax pool deductions**
- Producers will eventually become taxable if they continue to pay dividends. Cash **tax rates expected to be 10-12% of pre-tax cash flow** due to ongoing deductibility of capital expenditures.

- **Reinvestment Ratios and Expected Growth Rates**

- Conversions to “**hybrid model**” **expected for most trusts**
- Greater than 50% re-investment ratio required to sustain production and reserves for most trusts
- Technological rejuvenation of Resource and Legacy plays
- Only best trusts positioned to show some (5-7%) growth: ARC, Baytex, COS, Bonavista and Vermilion
- Debt-to-Cash Flow ratios about 1.5 times estimated 2011

- **Dividend Policies With Current Price Deck**

- Soon-to-be dividend yields in the 7-9% range
- Distributions reduced sufficiently in 2008-09 such that additional **cuts not required**



# Expect Oil Prices Stabilize Between \$70-80 in 2010-12

Crude Oil Forecast (WTI)

		Q1	Q2	Q3	Q4	Annual	
	2007	---	---	---	---	\$72.30	
	2008	\$97.85	\$123.80	\$118.25	\$59.10	\$99.40	
	2009	\$43.00	\$59.00	\$65.00	\$74.50	\$61.90	
Sequential Earnings Improvement →	2010E	---	---	---	---	\$80.50	} Groppe
	2011E	---	---	---	---	\$70.00	
	2012E	---	---	---	---	\$78.50	
	2013E	---	---	---	---	\$81.00	

Natural Gas Forecast (Henry Hub)

		Q1	Q2	Q3	Q4	Annual	
	2008	\$8.65	\$11.36	\$9.10	\$6.40	\$8.90	
	2009E	\$4.55	\$3.70	\$3.25	\$4.50	\$4.07	
Substantially Higher Natural Gas Prices →	2010E	---	---	---	---	\$7.15	} Groppe
	2011E	---	---	---	---	\$7.45	
	2012E	---	---	---	---	\$7.85	

**Natural Gas Prices Should be  
Substantially Higher by Springtime**

Source: Groppe, Long & Littell



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# Natural Gas Prices Moving Higher

- After Fall “shoulder”, expect natural gas prices to increase steadily to meet the marginal cost of production (**\$7-9 Mcf**).
- Lease retention drilling will subside.
- Shale marginal costs will continue to increase as core areas are depleted and because of environmental and regulatory issues. **Shale gas has at least twice the decline rate** as conventional gas.
- Futures **hedging** has minimized cash losses since the mid-2008, but now difficult to garner suitable hedge prices for significant volumes.
- The enthusiasm for shale has marginalized funding for conventional and tight resources that are probably cheaper to find and produce
- Technologies that have made shale plays possible can now be applied to higher quality reservoirs. **Huge ‘game changer’ for Canadian oil patch.**



# Shale Economics

- Companies state that shale gas is profitable at \$5/mcf or lower, but average unit cost from their financial statements is higher than that

Total Shale Company Costs	
	\$/mcf
Lease operating expenses	1.00
Gathering and transportation	0.50
Production taxes	0.50
<b>Total lease operating expense</b>	<b>2.00</b>
G&A costs	1.00
Interest expense	1.50
<b>Total operating expense</b>	<b>4.50</b>
Drilling costs	2.00
Acreage acquisition cost	1.50
<b>Total unit cost</b>	<b>\$8.00</b>



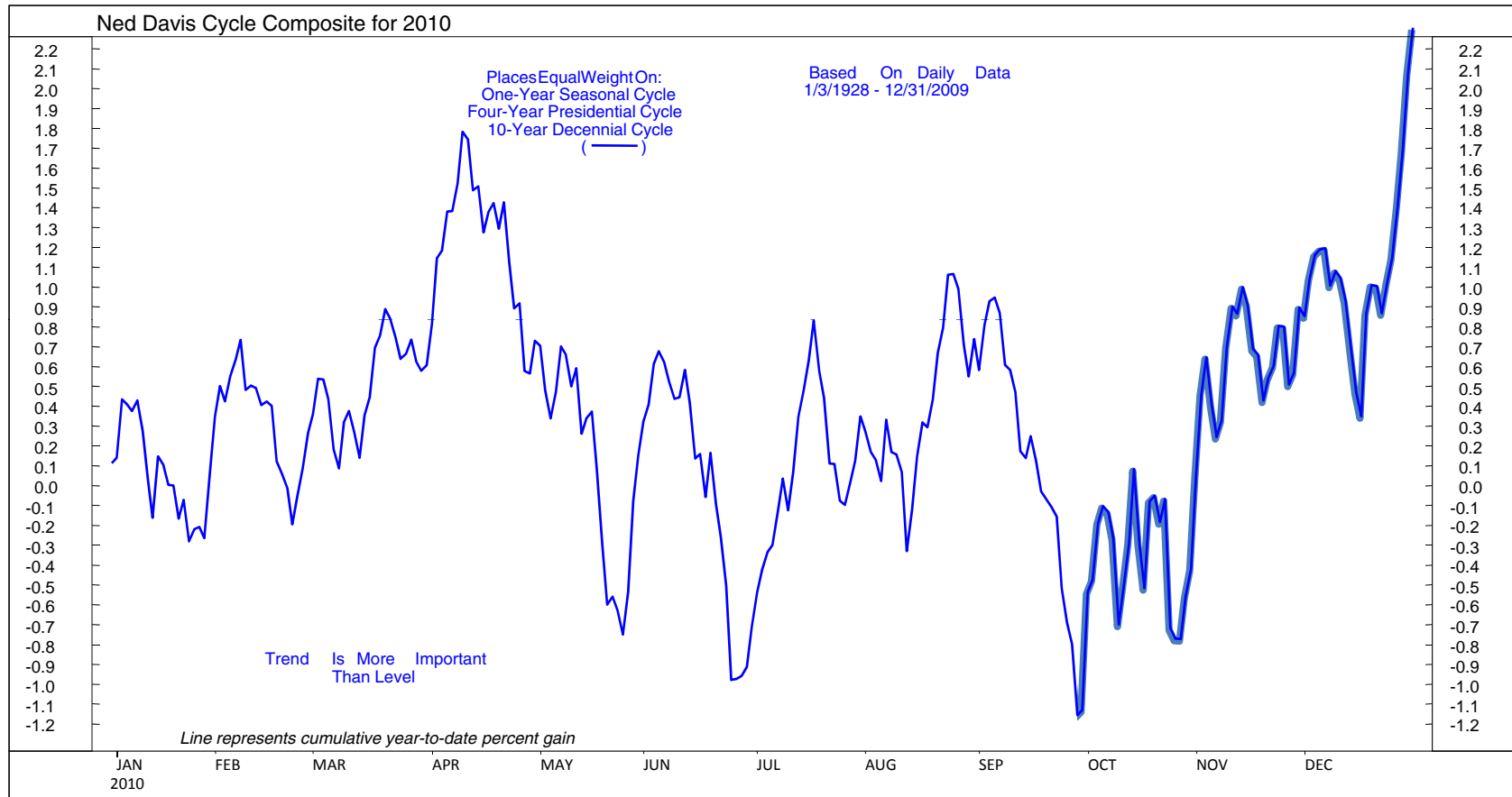
Source: Labyrinth Consulting

**Can no longer hedge forward to offset cash losses**



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# Ned Davis Roadmap for 2010



**Expecting a Strong Year-End Rally**



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## Key Takeaway

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- DIVIDENDS ARE A LOT MORE IMPORTANT THAN YOU THINK!
- TRUST IN DIVIDENDS



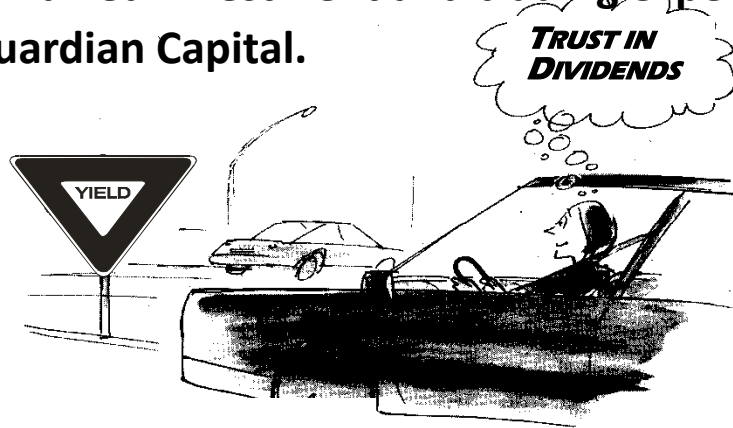
# Guardian Capital

- Established - 1962
- Assets - \$14.5 billion
- Stability
  - Ownership (Public Company Since 1969)
  - Personnel
  - Client Base
- Comfort
  - Independence (no conflicts)
  - Size (no constraints)
  - Focus (only money management)
  - Succession Planning (in place)
  - Code of Conduct (integrity / trust)
- Future
  - Controlled Growth



# Guardian's Equity Income Team

- **Over 140 years of combined investment and trading experience, 85 years of that at Guardian Capital.**



## INCOME TRUST TEAM:

JOHN PRIESTMAN, Managing Director

TED MACKLIN, Managing Director

KEVIN HALL, Senior Portfolio Manager

MICHELE ROBITAILLE, Senior Portfolio Manager

CAREN FIELDS, Research Analyst

ANTOINETTE VITRO, Assistant Research Analyst

DEBBIE LAWRENCE, Trader



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# Partnerships



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**For more information on  
Guardian Capital, please contact the  
Pinkowski-Allen Group at 604.659.8047**

**[www.pinkowski.ca](http://www.pinkowski.ca)**



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