THE WALL STREET TRANSCRIPT
Connecting Market Leaders with Investors

Balancing High-Dividend Income and Capital Appreciation

MARK D. THOMSON, MFA, CFA, is Managing Director, Equities of Beutel, Goodman & Company Ltd. Mr. Thomson joined Beutel Goodman in 1989 and has over 25 years of investment experience. He is responsible for oversight of the equity process and is a portfolio manager who leads the Canadian Equity Team. He is also the Chair of the Beutel Goodman Management Committee and Chair of the board of directors. Prior to joining Beutel Goodman, Mr. Thomson was a portfolio manager at Pemberton Securities. Mr. Thomson is a graduate of Mills College and is a CFA charterholder.

SECTOR — GENERAL INVESTING

TWST: We last spoke with you in 2010, Mr. Thomson. Are there any updates that you'd like to give us on Beutel Goodman?

Mr. Thomson: I have new roles on the board and the management committee. I continue to be the Managing Director, Equities. When we previously spoke, I believe we managed about C$19 billion. We are currently managing approximately C$37 billion in total assets as a firm. Over C$15 billion is in Canadian equities and C$5.6 billion is nondomestic or non-Canadian equities.

TWST: You manage the Canadian Dividend Fund. Can you tell us about that?

Mr. Thomson: The fund seeks a balance between high-dividend income and capital appreciation by investing in a diversified portfolio of blue-chip Canadian common stocks and, to a lesser extent, in high-yielding preferred shares and interest-bearing securities. It consists of names that have a minimum yield at purchase of 1.5%. To retain its classification in the Canadian dividend category, the dividend yield in the fund must exceed the TSX dividend index yield, which currently sits at 3.45%.

The fund can have no more than 30% invested in non-Canadian securities. The names in the portfolio are selected from our Canadian, U.S. and EAFE portfolios on the basis of quality, sustainable yield and return to target. If you look at the fund on a cumulative basis over the last seven to 10 years, it has outperformed the benchmark on the upside while providing significant downside protection. Given its relatively high return and lower risk, the portfolio is appropriate for most equity investors.

TWST: What do you believe are the key strengths of the Canadian Dividend Fund?

Mr. Thomson: The fund is based on a methodology and a philosophy that mitigates risk by focusing on quality businesses, thoroughly researched, that pay sustainable dividends and are trading below their value as a business. We have a minimum return requirement, 50% over three years, and a strict sell discipline. We are looking to take advantage of the arbitrage between a conservative private-market business value and the price that a business may be trading at in the public market.

TWST: Give us more detail on your buy and sell discipline.

Mr. Thomson: Preservation of capital is paramount to what we do. This holds true right across each of our asset classes, be it fixed income or equities. On the equity side, we believe the value of a business is determined by the present value of future free cash flows. If we can find stocks that are trading at a sufficient discount to this business value to generate a minimum of 50% total return, then we will buy them. We also believe that if we purchase companies that have significant discounts to their business value, not only will there be an adequate return, but we can minimize risk.

We believe that stocks will not trade on a sustainable basis above their business value, and therefore, we will not hold expensive securities in the portfolio. We have a definitive sell price, set at purchase, where we sell at least one-third of our position when a stock hits our sell target. Stocks that are in favor are customarily expensive, and we will not buy or hold them.

TWST: This is a defensive fund, which performs well in volatile markets. Why is that?

Mr. Thomson: Primarily because we own quality businesses with low valuations. We have a bias toward companies with good balance sheets, and firms that pay attractive and sustainable dividends. As a group, they are businesses that earn their cost of capital, which means that they generate free cash flow. Free cash flows pay dividends, which historically have accounted for roughly 70% to 80% of equity returns globally. Free cash flow also enables companies to reinvest in their businesses, make acquisitions and retain a good balance sheet. I think this bias to quality and the sensitivity to price has created a balance that's worked extremely well.

TWST: How do you feel the Canadian markets have been impacted by macro events?

Mr. Thomson: We are in a low-growth global economic environment at the moment, which means that excess liquidity should favor equity markets. Having said that, commodities tend to do poorly in low-growth environments. With energy and materials accounting for approximately 28% of the TSX currently by weight, the Canadian market currently has significant headwinds. As such, our expectations for prospective equity returns going forward tend to favor nondomestic markets.

In addition, the Canadian market is somewhat compromised by the inability to find free-cash-flow-generative stocks in some sectors. Having said this, the dividend portfolio currently contains only free-cash-flow-generative businesses. This is in sharp contrast with the TSX, where approximately 65% to 70% of the index generates free cash flow.

Highlights

Mark D. Thomson discusses Beutel, Goodman & Company Ltd. and the Canadian Dividend Fund. The fund invests in blue-chip Canadian stocks, as well as high yielding preferred shares and interest-bearing securities. The goal of this diversified portfolio is to achieve a balance between high-dividend income and capital appreciation. Names are selected for the fund on the basis of quality, sustainable yield and return to target, which results in a portfolio with relatively high returns and lower risk. Mr. Thomson minimizes risk by buying companies at a significant discount to its value. He also maintains a strict sell discipline and requires holdings to have a minimum return requirement of 50% over three years.

Companies discussed: Eli Lilly and Co. (NYSE:LLY); Rogers Communications (TSE:RCI.A); Molson Coors Brewing Company (NYSE:TAP); Verizon Communications (NYSE:VZ); Toronto-Dominion Bank (TSE:TD); Royal Bank of Canada (TSE:RY); Cenovus Energy (TSE:CVE); Suncor Energy (TSE:SU); Imperial Oil Limited (TSE:IMO); Kellogg Company (NYSE:K) and Merck & Co. (NYSE:MRK).

of a lower Canadian dollar, left the country in the 1990s. Canadian businesses that no longer manufacture in Canada will not benefit from a low dollar. From an investors' perspective, obviously, the drop in the Canadian dollar has benefited holdings that are listed outside of Canada, particularly in the U.S.

TWST: I know that it's impossible to look into the future and prognosticate what will happen, but do you think that in the future the Canadian dollar is going to level again with the U.S. dollar?

Mr. Thomson: The dollar can trade above intrinsic value for a fairly extended period of time. If you use purchasing power parity or labor costs, it would appear that the Canadian dollar should be priced around $0.78. Based on history, however, making a short to medium call on the Canadian dollar would be fruitless. If you look at history, the Canadian dollar has been sustainably above or below its intrinsic for periods of five to 10 years.

TWST: You like to ensure the balance between high-dividend income and capital growth. Can you tell us about the approach you take please?

Mr. Thomson: Although we have a minimum dividend yield, we are focused entirely on total returns. We have a three-year time horizon, and we set a target minimum return of 50% inclusive of dividends. We will not own a stock that has 1.5% or lower dividend at purchase. We are a dividend fund, so dividends are an important contributor to total return. As long as we meet the basic criteria for the dividend fund classification in Canada, which means that we have a premium yield to the TSX dividend index, we are agnostic to where our returns come from.

A risky strategy for a dividend fund is to focus on yield without considering sustainability. We saw this risk manifest itself with investors in some of the energy stocks going back a year or two. Dividends are important, but they must be intrinsically supported by the business over time, and the payout ratios must be sufficient that even if the environment turns hostile, dividends will not be cut.

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TWST: How has this steered your decisions in terms of holdings?

Mr. Thomson: We don't start from a macro perspective. We tend to have a bias toward businesses that are not dependent upon outside forces to make good on their promise. If the business is good, the quality of the balance sheet is solid, the valuation is attractive and the dividend is sustainable, we will buy and own a stock.

TWST: How do you feel that the higher U.S. dollar has affected the Canadian markets? Is there any way that Canadian investors can make the most of that?

Mr. Thomson: From an economic perspective, on the whole, we are not a significant beneficiary of the lower Canadian dollar. Some commodity producers will benefit from lower costs and higher revenues, but that will only shift their prospects from bad to less bad. A lot of our industrial base, which would have been a direct beneficiary

TWST: How do you determine allocation and diversification in your fund?

Mr. Thomson: We feel we don't have to be in a specific sector, no matter how popular, if it doesn't meet our quality and return criteria. If a sector is too popular, it is likely to be trading at a premium to business value and, therefore, is risky. The ability to invest outside of the country allows us to diversify the fund and seek out quality businesses that earn their cost of capital. This is not always the case when investors are restricted to the TSX.

1-Year Daily Chart of Eli Lilly and Co.

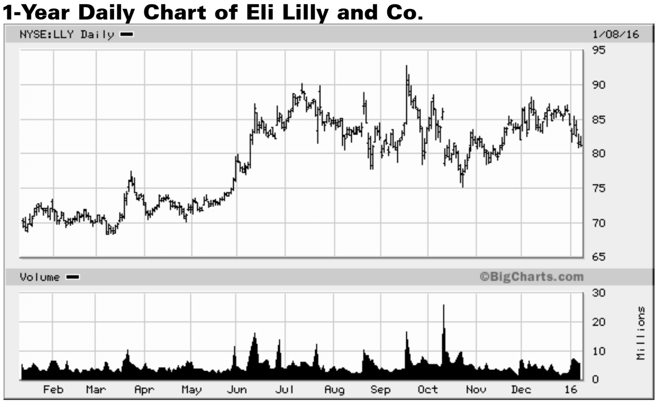

Chart provided by www.BigCharts.com

has transitioned over time. The government-guaranteed mortgage book has gone from 25% to 45% over the last 20 years and now accounts for over 50% of all loans. At the same time, fee income, largely unrelated to credit, has gone from 30% to 50% of earnings. As such, the business is now much less sensitive to the credit cycle than historical experience would indicate.

As far as cyclicality of the business goes, if you look back at the experience of 2008, which was one of the worst environments in 80-plus years, earnings in retail banking were down less than 5%. The banks generate a lot of capital over time and account for an outsize contribution to the total TSX earnings. The Canadian banks currently account for approximately 40% of the TSX earnings, yet their weight in the index is only about 22%. Retail banking is one of the best stable businesses in Canada, yet the banks are trading at valuations that are at a discount to low-quality cyclicals.

We like **TD's** U.S. exposure, as they are the seventh- or eighth-largest retail bank in America. In addition, they went through the last credit cycle with losses that were a fraction of their competitors. In Canada, they have over 25% market share, which over time, should give them operating leverage. Most importantly, they have a risk culture that has few peers. If you look back at 2008, **TD**, unlike many of its peers, was largely unscathed. The company has consistently gained market share in the retail-banking segments that are sustainable, primarily core deposits. We think it's a stock where a much higher valuation is appropriate.

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TWST: Are there any sectors that you feel are unduly popular right now or overvalued?

Mr. Thomson: Ironically, if we don't get an upturn on the basic commodity prices, the sectors that have been hit dramatically from a price perspective over the last couple of years — the materials and the energy sector — may prove to be the most expensive. Despite the price declines, many investors, informed by the post-2000 commodity rally, are paying up for stocks that are discounting much higher commodity prices. We own some commodity producers, but we are very selective.

TWST: What were some of your best-performing stocks in 2015, and what looks beguiling as we move into 2016?

Mr. Thomson: The best-performing stock in the portfolio was **Eli Lilly** (NYSE:LLY), the American pharmaceutical. Our second-best-performing stock was **Rogers Communications** (TSE:RCI.A). New management has come in and made investors much more appreciative of the underlying business. **Molson Coors** (NYSE:TAP) was our third-best performer. The company has been a good, stable business over time and trades at a decent valuation. Going forward, it is likely to be a consolidation of a joint venture with **Miller**, which will be very accretive. **Verizon Communications** (NYSE:VZ), a company in an industry that is out of favor but with low expectations and a high, sustainable yield, has been a good stock.

TWST: One of your top holdings is Toronto-Dominion (TSE:TD). Why do you like that name?

Mr. Thomson: Let me give you a bit of background on the Canadian banks. They are very much out of favor with investors focusing on exposure to the oil patch and Canadian housing market valuations. Lost in this focus is an appreciation of how the business

1-Year Daily Chart of Molson Coors Brewing Company

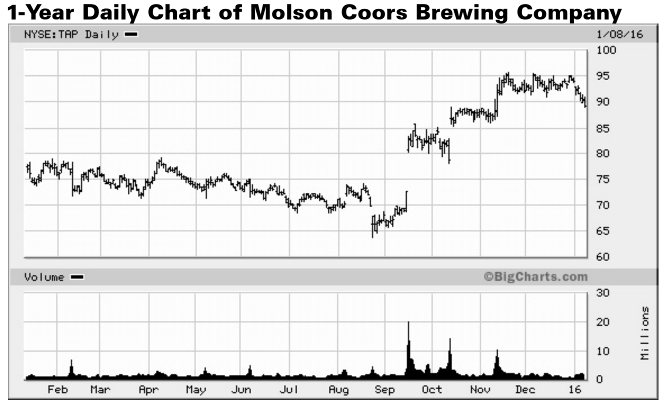

Chart provided by www.BigCharts.com

TWST: Would you put Royal Bank of Canada in the same boat?

Mr. Thomson: Royal Bank of Canada (TSE:RY) and **TD** together have about 50% of the Canadian banking market. Firstly, we are very comfortable with the management of both firms, as they are bankers that actually understand banking. Over time, I think both firms are going to make the right allocation of their excess-capital-generation capability.

Secondly, they have very good exposure to higher rates if they should happen. Both firms have strong risk cultures and high market shares that should translate any revenue growth into higher earnings.

TWST: Would you put the Canadian insurance companies in the same boat as the banks? Do you think they are also undervalued?

Mr. Thomson: Somewhat, but not to the same degree. If you look at ROE-adjusted price to book, which is our primary metric, the discount of the Canadian banks is such that we see them, even in this current environment, as providing 50% returns over the next three years. We don't see that with the insurers.

The insurers, going back a couple of years, had very attractive returns. At that time, I don't think people really appreciated the sustainability and the stability of the insurance business, as they were still focusing on potential exposure to bond and stock market fluctuations. Since then, the concerns have been allayed, and the insurance stocks have done very well. Insurers are good businesses that are reasonably priced currently. Banks, on the other hand, are better businesses that are cheaply priced.

TWST: Can you tell us why Cenovus is in your top holdings?

Mr. Thomson: Obviously, oil pricing is very bad right now, and it may stay low for a long period of time. We are not going to make that call. In the current environment, we want companies that have a low cost position in the industry, and **Cenovus** (TSE:CVE) fits the bill, as they are the industry-leading SAGD oil sands developer. They have the lowest steam-to-oil-ratio projects in the industry, and they are economic at $45 a barrel. They have very low capital intensity, and they are not facing penalties for carbon costs.

The key issue remaining for the company, outside of oil prices, is the oil sands royalty review. Given what we have seen from the Alberta government to date, we don't think the outcome will be onerous. **Cenovus** is free-cash-flow-neutral at $45 WTI, and they cover their dividends at $50. On top of that, the balance sheet is the cleanest in the industry at under 1 times 2016 net debt to EBITDA. They have $4 billion in cash, and the debt term on average is 16 years.

Cenovus has the ability to wait the downturn out. If oil does recover, we see them, unlike some of the integrated producers — i.e., the **Suncors** (TSE:SU) and **IMOs** (TSE:IMO) of the world — as having returns that are significantly better than 50%. Some of the other quality names — i.e., the ones with more refining exposure — may have downside protection but, because of their valuations, have constrained upsides.

TWST: You also like Kellogg. Tell us about this name.

Mr. Thomson: People are familiar with the breakfast-cereal side of the company where they have a one-third market share and are a dominant player in the world. With the acquisition of **Keebler** in 2000 and more recently Pringles, **Kellogg** (NYSE:K) has become the second-largest industry player in snack foods. The stock market's focus on slightly declining market cereal-consumption trends in the U.S. has provided a buying opportunity. Our perspective is that the impact of U.S. consumption trends is overstated. Cereal consumption is still a growth market outside the U.S., and North American cereal is only about 23% of **Kellogg's** total revenues and less than domestic snack-food sales.

Kellogg is also a good example of an investment that has excellent underlying assets that have been undermanaged. Their cash flow returns to capital has been consistently high, in the mid-20 range, and this has led to complacency on how their operations were managed. The company has a new CEO, John Bryant, and there is intense pressure to fix the operational side. There has been a broad restructuring of operations and a simplification of manufacturing assets.

The margin expansion from restructuring and improving market position in cereal, particularly fixing the Kashi brand, should drive higher free cash flows. We expect their EBIT margins to expand to 15% by 2017 versus 12% in 2011 to 2012. **Kellogg** is a high-conviction name where we see well-defined risk and high returns going forward.

TWS: Outside of North America, what other names entice you?

Mr. Thomson: We like **Merck** (NYSE:MRK), the German pharmaceutical name that is largely misunderstood in the market from our perspective. We see this as a high-quality company with low valuations that should give us very good returns.

TWST: Given our current economic context, what advice would you give to investors?

Mr. Thomson: Don't be too heavily influenced by conventional macro trends. Focus instead on buying high-quality businesses with low valuations and sustainable dividend yields. When those same companies gain favor in the market, and investors and analysts focus on the exciting prospects for the business and ignore valuations, sell a significant portion of your investment.

TWST: Thank you. (KK)

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