DM Portfolio Commentary

1st QUARTER 2016

Follow the cash, forget about the noise

January was ugly. Crude oil's merciless slide took it briefly below $30 a barrel, the Canadian dollar touched 68 cents against the greenback, and the S&P 500 suffered its worst start to a calendar year – *ever*. Not unexpectedly, this tempest summoned the usual parade of pessimists, many who've now been forecasting a market crash for well over half a decade. As it happened, though, the early dip didn't set off the next "big one" and, by the close of the quarter, oil had rallied by almost 30%, the loonie gained more than 12%, and major North American equity benchmarks had reclaimed all of their lost ground and more. In fact, the Dow posted its greatest in-quarter recovery since 1933.

DM Canadian Equity Portfolio	Q1 ANNOUNCEMENT		DM Foreign Equity Portfolio	Q1 ANNOUNCEMENT	
Agrium Inc.		S	3M Company	D	S
Bank of Nova Scotia	D		Cisco Systems	D	S
CN Rail	D		CME Group	D	
Gildan Activewear	D	S	Danaher Corp.	D	
Home Capital Group	D	S	Diageo PLC	D	
Magna International	D		Express Scripts Inc.		S
Manulife Financial	D		Intl. Flavors & Frag.		S
Royal Bank of Cda	D		JP Morgan Chase		S
Thomson-Reuters	D	S	Oracle Corp.		S
TD Bank	D		Qualcomm Inc.	D	
Transforce Inc.		S	Starwood Ppty Trust		S

So does this mean that the coast is clear for stocks and it's nothing but up from here? Likely not. The same distractions that have been worrying investors for years now – *central bank profligacy, European lethargy, Middle East anarchy* – are still with us and some combination of these or other worries will surely roil markets at some point in the not distant future. As we experienced in Q1, however, stock prices eventually revert to fundamentals once short term panic subsides and, right now, the fundamentals are probably better than many observers are willing to believe.

Even before taking into account aggregate metrics such as valuation, corporate financial health, and interest rate levels (which range from reasonable to compelling), we had a strong sense that underlying business conditions for the companies in DM portfolios were far more favourable than their share prices were temporarily indicating. This confidence was supported by our meetings with management teams and the positive signals they were sending through capital allocation decisions, even while investors were demonstrably bracing for a downturn. The accompanying table lists the stocks in the DM Canadian Equity Portfolio and those in the DM Foreign Equity Portfolio which announced either dividend increases (**D**) or new/expanded share repurchase programs (**S**), or both, during the first quarter.

While the rest of the world was fretting, 11 companies in each of our core portfolios – or fully 1/3 of holdings – elected to return capital to shareholders in some form over the past three months. Letting go of cash through dividend increases or share buybacks is not a course typically taken by executives worried about the near future for their enterprises; rather, when companies sense that sales are plateauing, margins are being pressured, or financial conditions are deteriorating, they tend to hoard liquidity and pad balance sheets. By distributing capital, management groups send the message that current and expected cash flow generation is more than sufficient to meet internal capital needs and that they don't foresee any major potholes which might persuade them to build a safety net.

Of particular note from the Canadian column are CN Rail and Gildan Activewear, each of which boosted its dividend by 20%, as well as Transforce and Home Capital Group, which launched notable share repurchase programs. Home Cap's buyback was particularly powerful, not only providing a steady bid under its shares, but also reaffirming the strength of both its finances and mortgage lending operations; this conviction helped to drive the stock higher by more than 50% from its January low. On the foreign side, dividend growth was paced by Danaher, CME Group, and Cisco, which lifted payouts by 19-24%, while Express Scripts announced a new "accelerated share repurchase" program valued at $2.8 billion.

As the first quarter of 2016 has shown in extremely compressed fashion, the interim trajectory of a stock's price often bears little correlation to the fortunes of its underlying business. Though markets have been choppy in recent quarters, with capital appreciation harder to come by, our meetings with management teams in recent months have cast a much more positive light on business conditions than their companies' shares have been portraying. We expect that the stocks in DM portfolios will provide additional capital distribution over the balance of 2016, which will not only boost the intrinsic value of holdings, but reaffirm corporate confidence in both broad business conditions and each firm's unique position in the marketplace.