BCV Asset Management Inc.

The Blue Chip Report
January 2017

Reflections on 2016 and Thoughts on 2017

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The financial markets experienced two big surprises in 2016- the United Kingdom voted to leave the European Union in the so-called Brexit vote and the United States elected Donald Trump as President. In June, the Brexit vote rattled the political and financial consensus, resulting in a narrow victory for the 'leave' camp. In November, the world was shocked with the election of Donald Trump. Neither event was expected by the pollsters- while the Brexit vote was anticipated to be close, Trump was expected to lose convincingly.

Financial markets were not prepared for either decision, but they reacted very surprisingly to these unexpected outcomes. It was widely believed, with some reasonable basis, that both Brexit and a Trump presidency would be disastrous for capital markets. The Brexit panic lasted only a few days before investors came to realize this decision will unfold slowly and most businesses in the United Kingdom and around the world would continue to prosper. The widely-predicted financial panic following the Trump victory did not even last one day, with markets opening stronger on the day after and closing the year full of optimism. Both examples remind us that it is extremely difficult to predict what happens in the capital markets and that those predictions are fraught with errors.

To the surprise of many, equity markets in the United States had a strong year, with the Standard & Poor's 500 Index rising by 9.5 percent and the Dow Jones Industrial Index rising by 13.4 percent. Canada had an outstanding year, in contrast to the extreme pessimism that many investors had at the beginning of the year. The slowly-rising price of crude oil and the inexpensive valuations at the start of the year that followed a lackluster 2015 provided the impetus for the S&P/TSX Composite Index to rise by 17.5 percent in 2016.

As we look forward to 2017 and think about how the capital markets will unfold this year, we think that it is unlikely that will see the same kind of political surprises that we did in the year that just ended. There will be elections upcoming in France and Germany and possibly in Italy, where the results could roil financial markets if more populist anti-European Union parties gain greater power. China continues to try to stem capital outflows as their financial system weakens. We could potentially see significant geopolitical change as Trump changes current foreign policy in Asia and the Middle East with unknown effects. Even bigger changes could occur on the international trade front as the Trump administration tries to provide incentives to bring manufacturing jobs back to the United States, especially from Mexico and China, as well as potentially introducing import tariffs and taxes to further protect domestic manufacturers. These anti-globalization policies will likely have near-term negative implications for corporate profits and the equity markets in general. If the Trump administration is successful in lowering taxes broadly, introducing a fiscal stimulus package and reducing the role of government by expanding deregulation, this should lead to positive outcomes for corporate earnings and the equity markets.

Canada will also benefit from a stronger economy in the United States, as that strength helps Canadian exports. The already-tepid Canadian economy may need that help, as new regulations for mortgage insurance are expected to slow the housing market and new carbon taxes overhang the economy. The troubles may only increase if the new protectionism in the United States extends to Canada, given that three-quarters of our exports are to the United States.

The path that the equity and fixed income markets will take in 2017 is difficult to predict. Equity valuations are no longer inexpensive, but investors are fairly optimistic and animal spirits are alive and well. We have been in a bull market since 2009, which is quite lengthy when viewed against historical precedent. If we combine this with the prospect of rising interest rates, at least in the United States, it is probably a reasonable conjecture to say that markets could face some considerable turbulence looking forward.

Fortunately, correct capital markets predictions are not needed to make successful long-term investment decisions. Turbulence in capital markets should not be a determining factor in decision making. Warren Buffett, who is arguably the world's most successful long-term investor, tries to factor out the daily pricing mechanism of capital markets.

"I never attempt to make money on the stock market. I buy on the assumption that they could close the market the next day and not reopen it for five years."

While we look forward to an uncertain environment, we choose to take a similar approach. We look three to five years into the future, focusing on two things that we can control- buying quality businesses and doing it at appropriate prices. That is more important than trying to predict investor reaction in the capital markets to constantly changing economic and political environments. Stock prices are inherently tied to future earnings and dividends, so finding companies that can grow their business conservatively is the key to long-term investing success. We will continue to own profitable, successful businesses that reward investors with rising dividends and we will constantly review those companies and search for others that are better than the ones we have invested in. We will avoid overvalued companies and sectors of the market and those companies that we believe have faltering dynamics. Over the long term, we believe that this will be rewarding, even though we will have to endure the volatility that whipsaws the markets up and down. In 2016, overall investor sentiment was a tailwind and while that tailwind may continue in 2017, it also may not. We remain quite confident that the companies in our portfolios will increase their earnings and dividends in 2017 and in the years' beyond. That is what matters in the long term.

Why Dividends Matter

Ben Kelly, MBA, CFA

As we start a new year, it might be helpful for investors to brush up on some of the important reasons why we follow a dividend growth investment strategy at BCV Asset Management. The starting point of this exercise is a look at the foundational question of why dividends matter and how dividends factor into driving stock returns.

Dividends are important because they are a signal of a firm's fundamentals. A dividend declaration is like a vote of confidence by management, not only affirming that there will enough cash to pay the dividend and to allow the company to continue to operate, but also stating that it has set an expectation for a certain level of earnings and cash flow in the future. Companies use stable and increasing dividends as a signal of confidence in their prospects. The ability to pay an increasing dividend is a sign of corporate maturity and balance sheet strength and an indicator of the firm's earnings and growth prospects.

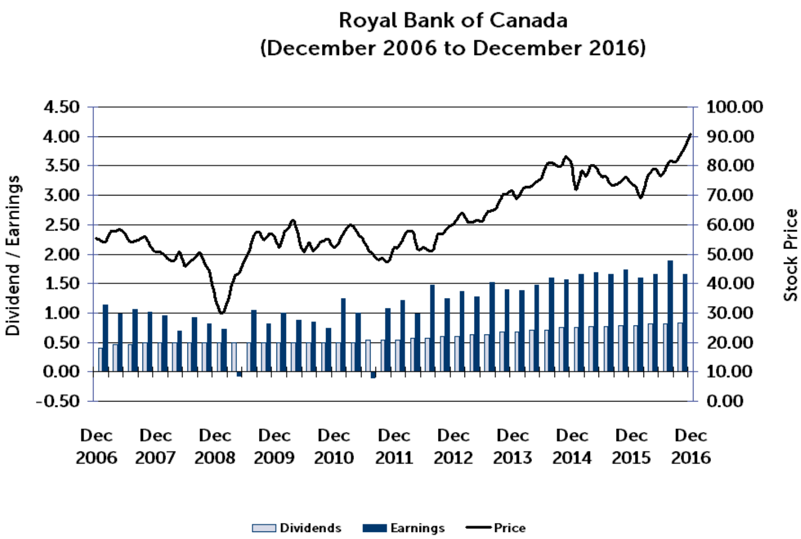
Dividends are also an important contributor to equity investment returns. In some decades, like the 1940s and 1970s, dividend income accounted for more than half of the total return of the Standard & Poor's 500 Index. Over the last ninety years, dividend income represented about one-third of the total return of that index.

Dividends are a key factor in accelerating wealth accumulation. Through the simple and powerful process of compounding, increased investment capital produces even more income. An investor who invested one dollar in the Standard & Poor's 500 Index on January 1st 1930, but never bothered to reinvest the dividends, would have seen that initial investment grow to $95 at the end of April 2016. If that same investor had reinvested the dividends, the initial investment would have grown to $2,796.

As portfolio managers, our challenge is not only to find companies that pay a dividend, but rather those that are likely to increase their dividend consistently in the future. Dividend growth is very important because it is the best dividend growth companies that possess a strong likelihood of outperformance over time.

The Standard & Poor's 500 Dividend Aristocrats Index consists of companies that have increased their dividend for at least twenty-five consecutive years. This index is often used as a proxy to track the performance of dividend growth companies. Historically, this Standard & Poor's 500 Dividend Aristocrats Index has outperformed the Standard & Poor's 500 Index. Since the inception of the Dividend Aristocrats Index in 1990, it has experienced a cumulative rate of return of 901 percent while the Standard & Poor's 500 Index has only had a 469 percent cumulative rate of return. The only time that the Dividend Aristocrats Index underperformed was during the dot.com bubble of the 1990s, when technology companies widely and temporarily outperformed the more conservative companies in the Dividend Aristocrats Index. The outperformance of the index confirms what our investment philosophy and track record have confirmed as well- investing in dividend growth companies is the key to creating wealth in the stock market.

The example of Royal Bank of Canada illustrates these concepts neatly. Looking back over the last ten years, the stock price increased as earnings increased. As earnings increased, the dividend also increased, but only a portion of the earnings are paid out as a dividend to provide the bank with capital to grow its business and to provide a buffer in times of earnings volatility.



Simply put, dividends matter. History shows that investing in a diversified portfolio of blue chip, dividend growth companies is the best way to create and grow wealth over the long-term in the stock market.

The United States Economy Mends, Is Canada Next?

James McInnis, B.Comm (Honours), CFA

At any period in history, there has been uncertainty- whether it be geopolitical risk, economic uncertainty, or conflict in regions of the world- and today is no different. As we begin the new year, we see political uncertainty in the United States and Europe, uncertainty about the level of sovereign debt (including China), social unrest about immigration policies in Europe, a bond bubble created by a persistent low interest environment, low labour productivity, and an aging population in the developed world. This is a list that could go on, but what does this all mean and is any of this important? As portfolio managers, it is worth knowing and monitoring, but it is also important to remain rational and keep our emotions at bay. With a bottom-up investment philosophy, we make our decisions based on the investment fundamentals of a company, but we are also keenly aware of the environment in which the company operates and investor sentiment as part of the decision-making process.

We continue to believe that equities will provide superior returns to bonds in 2017. The United States remains the main driver of our optimism, but we also see economic growth in Japan and an economic recovery in Europe. We remain vigilant towards Europe because of the political uncertainty surrounding upcoming elections in France, Germany and the Netherlands, as well as a possible one in Italy. We also expect that the equity market in the United States will outperform Canada, based on our opinion that there is better value in there on a risk-return basis. While the seeds for economic success were planted before Trump's nomination, his victory has only accelerated its course on hopes of a more business-friendly climate, less regulation, and less political gridlock.

In the United States, we draw our optimism from a cross-section of economic data. The housing market is healthy, with prices rebounding from their low point of five years ago. The employment market is robust, with jobless claims at a four-decade low and unemployment at 4.7 percent, causing real wages to finally begin to rise, specifically in the important middle class. Consumer confidence has risen to levels not seen since 2001 as consumers remain upbeat about the prospects for the economy, labour markets and incomes in the upcoming year. This represents a significant positive for the economy in the United States because consumers represent two-thirds of the demand for goods and services in that economy. Interest rates remain low, even as they begin to ascend from historic lows. There is hope for economic stimulus from the Trump administration's plans to deliver an infrastructure stimulus package and lower taxes. Investors have reason to be optimistic about the economy in the United States. We continue to see excellent opportunities in a wide variety of sectors, where investors could find good value in the market.

In Canada, we expect returns to lag those in the United States, barring a major correction in the housing market. The price of crude oil has the potential to further lift the Canadian equity market, as members of the Organization of Petroleum Exporting Countries (OPEC) have begun to reduce production to boost the price of crude oil. We believe that even if OPEC is successful in this endeavor, new supply of crude oil from shale regions in the United States will come into the market, restraining further price increases. As is the case in the United States, the consumer is all-important to the Canadian equity markets. With the Canadian equity market near all-time highs and property values continuing to set records, this confidence could help to propel the economy in the upcoming year. The Bank of Canada is likely to keep interest rates unchanged in the near term, even though the October GDP report showed that the economy contracted by 0.3 percent that month. Interest rates remain low, but reducing them any further could push house prices higher, which runs counter to changes in down payment and mortgage insurance rules that were intended to cool the market. Keeping interest rates at low levels, which are below those in the United States, suggest that the Canadian dollar will weaken against the United States dollar, although a meaningful increase in the price of crude oil could change that.

We do not expect that Canadian market to repeat the 17.5 percent increase in the S&P/TSX Composite Index of 2016 because we believe that economic growth remains tepid. We continue to focus on important drivers of the Canadian economy- the amount of non-energy exports to the United States, the Canadian consumer (jobless claims, unemployment rate, consumer confidence), and the housing market. The fundamentals of our Canadian investments remain sound and valuations are being monitored constantly. In 2016, we sold several investments that appeared overvalued, despite being good companies. We always remain active in researching new opportunities.

While the Canadian market faces some risk from the housing bubble and rising consumer debt level, the economy in the United States has a meaningful influence on the markets there and here. Two cornerstones of Trump's economic policy, tax reform and capital repatriation, are positive in the short run, but come with risks over a longer horizon. Two key Trump nominees- Peter Navarro as Director of the National Trade Council and Mick Mulvaney as Director of the Office of Management and Budget- provide insight how policy might unfold under a Trump administration. Peter Navarro is a staunch China hawk who will likely be focused on raising tariffs to create higher import prices and to encourage companies to bring manufacturing jobs back to the United States. While this idea works in theory, the complexity of the supply chains for these imported goods makes the idea more difficult to implement in practice. It is likely that the short-run result will be that it becomes more expensive for Americans to buy these imported products, but the United States would gladly accept a bit of inflation to help them inflate their way out of their debt situation. Mick Mulvaney, a South Carolina Republican Congressman, is known as a fiscal hawk. He was first elected in 2010 as part of the Tea Party wave and is a founding member of the House Freedom Caucus, which pushes for reduced government spending. He is a critic of rising government debt levels, so it is likely that any future spending increases will be offset with spending cuts elsewhere. After his nomination, Mulvaney called for bringing fiscal sanity back to Washington and signaled a willingness to work with Congress to implement policies that are friendly to American businesses and workers. This might mean that idea of the inflation trade has gotten a bit ahead of itself and that stimulus spending might not lead to additional debt. Word are cheap, but optimism remains high. The hard work is in the doing. The success that the Trump administration has in implementing these policies is important to Canada because the United States is our largest trading partner and non-energy exports are important for our future growth.

Regardless of the headlines, we remain true to the investment philosophy that has served us well. We follow a dividend growth investment philosophy that focuses on investing in high quality companies with strong business fundamentals that pay and grow their dividend on a regular basis. This allows our investors to expect rising dividend income from their portfolios, regardless of market conditions.

Recent Dividend Increases

Canada

Fourth Quarter 2016:
Bank of Nova Scotia: 74 cents (72 cents)
Callidus Capital Corporation: 30 cents (25 cents)
Home Capital Group Inc.: 26 cents (24 cents)
Royal Bank of Canada: 83 cents (81 cents)
Sun Life Financial Inc.: 42 cents (40.5 cents)

First Quarter 2017 (Pending):
Canadian Imperial Bank of Commerce: 124 cents (121 cents)
Canadian Natural Resources Ltd.: 25 cents (23 cents)
National Bank of Canada: 56 cents (55 cents)
TELUS Corporation: 48 cents (46 cents)

United States

Fourth Quarter 2016:
Becton Dickinson & Company: 73 cents (66 cents)
Honeywell International Inc.: 66.5 cents (59.5 cents)
Microsoft Corporation: 39 cents (36 cents)
Starbucks Corporation: 25 cents (20 cents)
U.S. Bancorp: 28 cents (25.5 cents)
VISA Inc.: 16.5 cents (14 cents)
Verizon Communications Inc.: 57.75 cents (56.5 cents)

First Quarter 2017 (Pending):
None

Dividend Increases reported in domestic currency of common shares, except where noted.
* Dividend paid in USD.
Source: Bloomberg LP