BCV Asset Management Inc.

The Blue Chip Report
January 2019

Volatility ≠ Real Risk

Todd Johnson, CFA
Portfolio Manager

In capital markets the value of any asset is a function of future cash flows adjusted by a risk-free rate and the chance that adverse outcomes may occur in the future (also known as: RISK!). In the fourth quarter of 2018 we saw changes to all three basic variables in the benchmark setting capital markets of the United States. Certain companies have reported a noted slowdown in business linked loosely to the maturity of the business cycle and global trade uncertainty, the benchmark overnight interest rate of the United States Federal Reserve (which sets the risk-free rate) continues to rise, and investors 'view of the future' has darkened with decreased desire to accept risk. Those are the three fundamental reasons why we have seen falling prices in United States stock markets during this last quarter. However, when weakening fundamentals combine with stock markets that have unbalanced liquidity, wild swings in prices are bound to occur. This past December was abnormal.

How meaningful are these fluctuations in prices? Do they signal anything ominous, like what happened a decade ago? We don't believe so. This abnormal trading volatility is partially based on fundamentals; however, it has been amplified due to machine-based trading, fragmentation of trading venues and forced end-of-year tax loss selling. The latter likely being the primary cause. We would argue, these exaggerated movements in pricing are not meaningful to the long-term investor. If an investor has a limited need for liquidity, a long-time horizon and focuses on how their portfolio of companies will increase cash flows over time; then the current environment of volatile pricing represents more of an opportunity than a risk. If irrational short-term factors are exaggerating price changes, causing security prices to become inexpensive, a rational investor will buy and increase their positions or stay the course, but certainly not sell.

The media and many investors tend to focus on negative near-term risks when markets are volatile. Currently, many investors fear the next tweet from the 45th President of the United States, whether a recession will be triggered next year by a seemingly tone-deaf Federal Reserve, whether companies will miss quarterly earnings guidance, impacts of geopolitical risks, and so on. These are currently significant factors for the short-term investor but impossible to predict accurately and not overly significant for the investor needing solid returns over the next 5, 10 or 20 years. We remain dedicated to our philosophy of identifying investments with a low probability of permanent loss of capital. We seek to invest in companies with limited downside, reliable dividend income, and the opportunity for future gains. We will not sacrifice capturing dividend income and further growth in these companies even though markets are volatile and prone to exaggeration. These are challenging times that require patience, discipline and fortitude to act and soldier on. We continue to learn from the past and closely watch present conditions. Our focus though, is on the future and owning high quality, long-term investments irrespective of the current volatile markets.

What is the Dividend Telling Us and Should We Pay Attention?

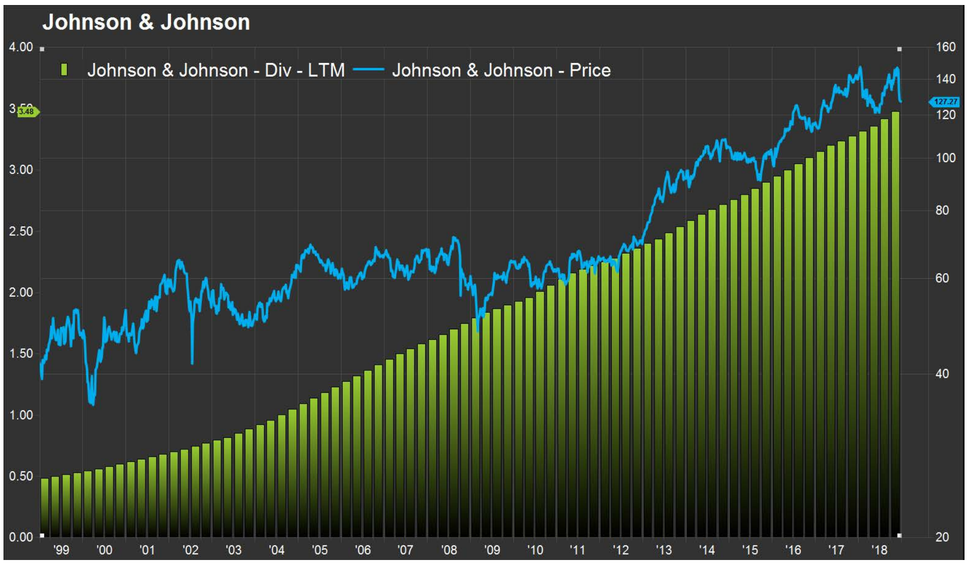
James McInnis, CFA
Portfolio Manager

With recent volatility in the market, we thought it would be timely to talk about risk. From a value investment perspective, one risk in a portfolio is that a company doesn't grow (or even cuts) its dividend, as equity valuations tend to be a function of future cash flows to shareholders.

We evaluate the ability of our companies to pay and grow their dividends. The share price may fluctuate in the short term but longer term, what arguably matters is the probability that a firm grows its dividend.

In Chart 1, we highlight the correlation between share price and the dividend of Johnson & Johnson over the past 20 years. The share price (blue line) tracks the growth of the trailing 12-month dividend (green bars). In fact, Johnson and Johnson has increased its dividend consistently over the past 46 years. As the dividend is a function of the valuation of the business upon which you are paid, dividend income becomes an integral part on your investment. As the dividend payment to you increases each year, the value of the shares should follow.

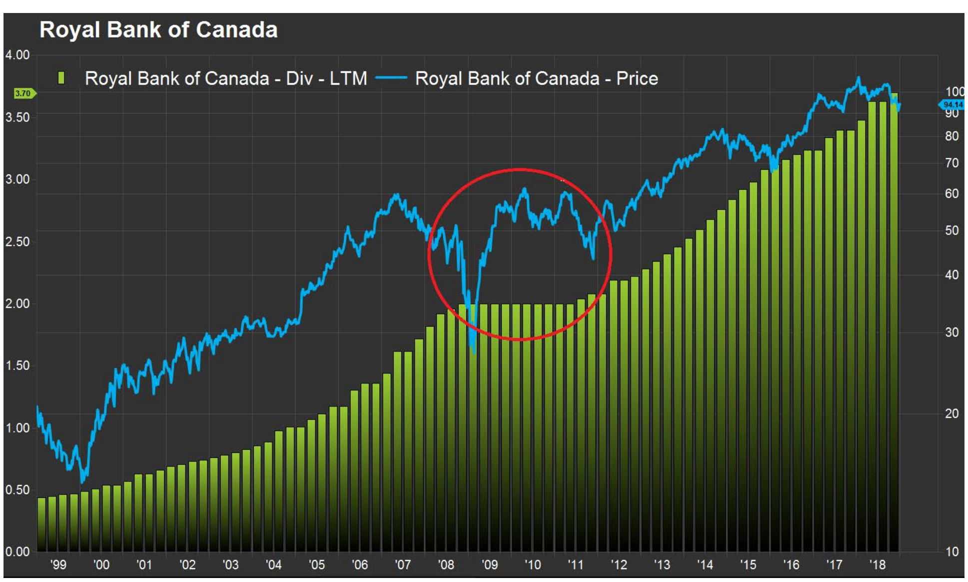
Chart 1



Source: FactSet & BCV Asset Management Inc.; Data as of January 2, 2019

Contrary to Johnson & Johnson, Chart 2 shows the same information for Royal Bank of Canada's share price and dividend over the same 20-year period. As we can see, the share price was effectively flat during the 2008 to 2011 period where dividend levels remained unchanged (circled in red). As dividend increases were reinstated, the share price followed. A dividend increase is a strong signal from the Board of Directors that there is confidence in the future earnings power of the company.

Chart 2



Source: FactSet & BCV Asset Management Inc.; Data as of January 2, 2019

The average dividend growth rate for the past five years for a typical security in our Canadian and United States Equity models was 9.9% and 11.7%, respectively. Annual growth in income at these rates is quite appealing, particularly so if you have retired and dividends are a meaningful portion of your retirement income. Owning high quality, dividend paying companies that grow their dividend regularly is easily understood and very effective.

We remind clients that while markets may be volatile, other factors remain consistent. Key features to remember are as follows:

1. BCV's philosophy and belief of a concentrated investment portfolio remains intact;
2. The income you receive from your portfolio is projected to be the same and expected to grow in the future;
3. Investment objectives remain unchanged;
4. Management of risk tolerance through asset allocation remains priority; and
5. Investment time horizon remains the same.

With 2018 now behind us, there are many investment opportunities as valuations are attractive. As we enter 2019, our holdings have a projected dividend yield of 4.3% in Canada and 2.8% in the United States.

Investment Policy Statement - Pointing the Ship in the Right Direction

Cory Lang, CFA, CPA, CA
Associate Portfolio Manager

When market volatility increases, it is a good time to consult the Investment Policy Statement (IPS). This document can often be overlooked as it is completed when an account is opened, and only periodically revisited when an investors' circumstances change. However, when a downturn occurs and causes some concern, the guiding principles of the IPS can help one get through the turbulence.

The IPS considers various special characteristics about an investor and gives the portfolio manager guidelines about how an investment portfolio will be managed. In addition, it will specify the objectives for the portfolio and any constraints that the investor has with respect to their investments. It is a roadmap for the portfolio manager to consider in order to reach the investor's unique goals and objectives.

There are several factors that are considered in the IPS. The desired investment return and risk tolerance are two significant items. An investor may require a specific desired return to meet specific objectives, and this will affect the asset mix of equity and fixed income securities within the portfolio. Note, this desired investment return is simply the theoretical return, not the actual portfolio return. The ability and willingness to accept risk will also be used by the portfolio manager to determine an appropriate asset mix. While it would be nice to have equity-like returns with minimal risk, there is clearly a trade-off. Higher risk tolerance will normally equate to more equity exposure, and correspondingly lower risk tolerance will mean less.

Another factor is time horizon. An investor who is relatively young and beginning their career has a longer time horizon than a similar investor who is nearing retirement. Of course, this presumes that the goal is to fund retirement. These investors may have varying objectives such as purchasing a home or maybe funding a child's or grandchild's education. Time horizon for an investor also changes due to life circumstances such as marriage, the birth of a child or even career change, among many other examples.

The need for income or capital for a major purchase are also incorporated into the IPS. These are referred to as liquidity needs and will accordingly affect the asset mix. An investor who is in retirement will have regular cash flow needs and this will be considered by the portfolio manager when determining asset allocation and security selection.

In addition, income tax considerations, regulatory factors and unique circumstances all play a further role in the development of the IPS. Investors with company owned stock may have low cost bases with large embedded and unrealized taxable capital gains, which could affect the timing of disposition. Regulatory factors may include an investor who is an insider of a publicly traded company who must follow certain procedures when buying or selling the company's shares. Unique circumstances would normally not affect the asset mix but could be noteworthy for the portfolio manager in managing the assets.

Why would all of this be affected by volatility in the market? First, the market values of equity and fixed income within the investment portfolio will likely change, thereby shifting asset mix. Secondly, it may be noted that we become more emotional when this change occurs. That's the time when we need to review the IPS and remember that a plan is in place to achieve our investment goals and objectives. The IPS is our roadmap for getting to our unique destination. A certain amount of volatility is inevitable, reviewing the long-term plan and IPS can ensure the right plan is in place and pointing the ship in the right direction.

Recent Dividend Increases

Canada

Fourth Quarter 2018:
Bank of Nova Scotia: 85 cents (82 cents)
Canadian Imperial Bank of Commerce: 136 cents (133 cents)
Manulife Financial Corporation: 25 cents (22 cents)
Royal Bank of Canada: 98 cents (94 cents)
Sun Life Financial, Inc.: 50 cents (47.5 cents)

First Quarter 2019 (Pending):
National Bank of Canada: 65 cents (62 cents)
Telus Corporation: 54.5 cents (52.5 cents)

United States

Fourth Quarter 2018:
Becton, Dickson and Company: 77 cents (75 cents)
Honeywell International Inc.: 82 cents (74.5 cents)
J.P. Morgan Chase & Co.: 80 cents (56 cents)
MIcrosoft Corporation: 46 cents (42 cents)
U.S. Bancorp: 37 cents (30 cents)
United Technologies Corporation: 73.5 cents (70 cents)

First Quarter 2019 (Pending):
None

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