

# Investing in Reality

— LEE W. APPLETON, CFA, PORTFOLIO MANAGER

It's official. Canada's recession is over according to the gross domestic product figures of December 2009. We're in the free and clear with expected 2009-2010 corporate earnings growth sitting at 20.0%. Or, are we? Based on our research and analysis, we believe market sentiment remains ahead of itself. We think there's a gap between investor attitudes and the economic realities and market results we'll likely experience over 2010. That's why we continue to build portfolios based on "real" fundamental strength, with each asset playing a substantive role in generating results that are expected to consistently outperform the benchmark S&P/TSX Composite Index. Looking at the Matco Equity Income portfolio, for instance, our asset selection criteria focuses on companies that:

- are profitable enough to produce higher dividend yields than the market;
- present a lower price-to-earnings multiple than the market; and
- based on the combination of the above, deliver lower volatility than the benchmark.

Looking "inside" the portfolio, you'll see an asset's contribution to overall portfolio strength at times supersedes its individual attributes. Take the following two companies for example:

## North West Company Fund

North West Company Fund owns The North West Company, which is recognized as "a leading retailer of food and everyday products and services in rural communities and urban neighbourhoods across northern and western Canada, Alaska as well as the South Pacific and Caribbean." It has approximately 6,800 employees and 223 retail locations. This asset has been part of the Matco Equity Income portfolio for 14 months, and as the table below shows, the company contributes positively in terms of all key portfolio characteristics. More specifically, the holding yields over 7.0% and its return-on-equity is very strong at 29.0%. (In our view, profitability and margins serve as important indicators of sustainable dividends). With a multiple of 11x earnings, we think North West is the most reasonably priced stock in the Canadian Consumer Staples, Food and Drug Retailing sector, while their noncyclical bottom-line earnings growth is strong relative to the markets.



## Yellow Pages Income Fund

Yellow Pages Group was added to the Matco Equity Income portfolio in November 2009. It's known as "Canada's leading local commercial search provider and largest directory publisher." The Group employs approximately 2,300 people in Canada and 350 in the United States.

You'll see the Yellow Pages Income Fund does not outperform the S&P/TSX Composite Index on all key characteristics. For example, the Yellow Pages Income Fund profitability/return-on-equity and reinvestment rate are, for example, lower than its peer North West Company Fund and the Index. So why own it? Fundamentally this asset "pays" its way by generating yields of approximately 15.0% on an ongoing basis. We expect the company's unit distribution policy to remain consistent given 2010 expected earnings of \$1.01, their reasonable payout ratio of 70.0% on trailing earnings and 60.0% on expected cash flow with dividends of \$.80. In addition, its very reasonable price at 5x earnings per share is very attractive. We view Yellow Pages Income Fund as a long-term opportunity within the context of the portfolio. In the near term, we expect the unit distribution to be the major return contribution until the market recognizes the business has undergone the typical recessionary cycle and not a secular change. When this occurs, we expect capital appreciation to also contribute as investor interest returns.

Working through this uncertain market environment, each asset in the Matco Equity Income portfolio will be selected and kept based on its specific attributes and, as importantly, its role in generating results. Strong key characteristics and prudent risk will, in our opinion, offer the best opportunity for total return, (combined income and capital appreciation), as the market reconciles any differences between the expected corporate earnings growth rate of 20.0% and the real growth of 2010. ■

		EQUITY INCOME	NORTH WEST FUND	YELLOW PAGES INCOME FUND	S&P/TSX COMPOSITE
Quality	Profitability/Return-on-Equity ROE (%)	15.6	29.5	9.4	12.0
	Reinvestment Rate (%)	7.1	5.8	-0.2	4.4
Income	Yield (%)	4.0	7.4	14.9	2.7
Growth	Bottom-Line Growth (%)	-7.0	3.8	-3.7	-12.9
Value	Price-to-Earnings	13.0	11.2	5.4	19.6
Risk	Beta-5 Years vs. S&P/TSX	0.8	0.2	0.4	1.0

As of December 31, 2009, CPMS.