

QV Investors



Performance

The Ethical Canadian Dividend Fund posted a 7.32% return in the quarter versus 4.4% for the S&P/TSX Composite Total Return Index (TSX). The one-year return was -4.0% for the Fund against -9.8% for the benchmark. The best and worst performers in the quarter were Astral Media Inc. and SNC-Lavalin Group Inc., respectively. Astral Media's stock price surged 34% from \$36.25 in March following BCE's proposal to acquire the company for \$50 per Class A share. We discuss SNC-Lavalin below.

Portfolio Commentary

Though we began with a conservative cash position of nearly 11.0%, we deployed cash over the quarter to end at 6.4%. We also removed two businesses from the Fund, Enerflex Ltd. and TransCanada Corp. Enerflex is engaged in the design and manufacture of natural gas compression systems. With its valuation stretched and near-term growth subdued, we took the opportunity to exit the position and reduce cyclical exposure. We removed our position in TransCanada for similar valuation reasons, including some balance sheet risk.

Attractive businesses still exist at good value. We introduced three new companies to the Fund in the quarter: ATCO Ltd. (ACO.x), Macdonald Dettwiler & Associates Ltd. (MDA), and Genworth MI Canada Inc. (MIC). ATCO is a complement to current Fund holding Canadian Utilities Ltd. (CU), of which it owns 52.7%. The valuation of CU is approaching high territory relative to the overall portfolio. But through ATCO we benefit from CU's regulated utility operations, and from a diversified portfolio of cash flow generating businesses at more reasonable valuation. MDA provides advanced information solutions to businesses and governments worldwide. The Company has a cash rich balance sheet and has lowered its debt every year since 2008 with plans to further reduce it annually. We applaud management's conservatism in combination with the Company's history of generating double-digit return on equity. Of the 32 businesses held in the Fund, 27 have increased dividends in the past year. MDA is one of them. The Company pays a dividend that currently yields 2.8%, slightly below the TSX yield of 2.9%. Genworth is Canada's largest private sector mortgage insurance provider.

The Company has a strong franchise built on good capital ratios and a high quality portfolio of borrowers.

Its valuation reflects the market's fear and uncertainty around the Canadian housing sector. We saw this as an opportunity to buy a solid business with consistent cash flow to support and grow its 5.4% dividend yield. Adding Genworth has assisted in safely improving the Fund's yield to 2.8% from 2.6% at the end of Q4 2011.

Shares of SNC-Lavalin, a global engineering and construction company, dove 23% in late February following news of lower expected earnings for 2011, including mysterious "period expenses" of \$35 million. In mid-March it announced the findings from its independent investigation surrounding these expenses and another \$20 million that led to the departure of its CEO. SNC plans to swiftly implement the improvements suggested by its Audit Committee. SNC's engineering and construction segment is trading at roughly 11 times its estimated 2012 earnings, compared to an industry median of around 16 times. It continues to win projects and grow its revenue backlog in light of current events. SNC also owns infrastructure assets that produce meaningful and stable cash flows. We cannot disregard its lack of management oversight. We are encouraged by the recent action on the part of the Board to rectify its problems of governance.

Outlook

The process of reining in debt throughout much of the developed world will continue to characterize the economic backdrop for the following 12 months and more. That being said, the United States economy remains the largest in the world and has recently been releasing some encouraging economic data. In particular, the much needed jobs picture seems to be improving. The market will be focused on the sustainability of employment growth over the year. On the other hand, the world's second largest economy, China, is trying to temper its growth and inflation rate. The hopes of the marketplace have been for a soft landing, or put another way a controlled slowdown from the overheated situation. These so-called soft landings are often tenuous and are one of the reasons we remain cautious on the elevated prices of many commodities.

The Fund is currently invested in nine industrial sectors. The majority of the portfolio pays dividends, with 27 companies having increased their dividends by a median rate of 11%, over the last year. The Portfolio is fundamentally strong with valuation, growth and balance sheet characteristics that remain attractive. The portfolio's dividend yield is 2.8%, which is significantly higher than that of 10 year Government of Canada bond yields.