

Standard Life Canadian Dividend Growth:

Recent struggles don't taint this fund's prospects

BY PHILIP LEE

This fund's long-term track record is admirable, but its ranking within the Canadian Dividend and Income Equity category has slipped over the past year. Nevertheless, we think management's strategy of focusing on companies that have the ability to grow cash flows and dividends remains intact. While a recent increase in exposure to resource stocks may increase short-term volatility, we're comfortable maintaining it as a top choice in the category.

Over the past year the fund has had a difficult time, with a 5.3% loss that stashes it in the third quartile. Financial stocks, which fit nicely with the mandate's dividend focus, have been hit hard as a result of the global liquidity crisis that began last summer. While many dividend funds faced similar headwinds, this fund was hurt more since it had a greater exposure to these stocks than many of its peers.

We were a little surprised with the additions of fertilizer producers Potash Corp. and Agrium Inc. (together representing about 2.3% of the fund) in the first quarter of 2008 given their miniscule dividend yields. Both stocks have risen over 150% in the last 12 months. Not holding these high fliers beforehand has hurt the fund's relative

performance since many of its top-performing peers previously had sizable positions in Research in Motion, Suncor Energy and Potash Corp.

We questioned management on whether the new positions were added to keep up with the Joneses. While the team admits to being late to the party, it believes in the companies' long-term prospects because growth in emerging nations will drive demand for food and fertilizer. We're not overly concerned with these additions, but we'll be keeping a close eye on management's stock selection to ensure that its strategy has not been compromised because of peer pressure.

The additions of the fertilizer names and the run-up in the fund's resource positions bring the fund's weight in cyclical sectors to 36% of assets, compared to 25% at the end of 2007. Although this will likely increase the fund's volatility given the active nature of these stocks, management has focused on those that pay a decent dividend – the average yield of the resource names is roughly 2.5%.

Standard Life Investments Inc. uses a team-based management approach. The managers use a bottom-up security selection process that focuses on companies with consistent cash flow and dividend growth. Such companies typically have management teams that have a history of improving shareholder value through dividends and share buybacks. In addition to focusing on dividend growth, the managers also pay attention to a stock's valuation by looking at its price-to-book, price-to-sales and price-to-earnings ratios. The team tracks roughly 200 stocks in the Canadian equity universe and sets upside targets and

downside limits on all stocks it covers.

What the team has been doing has worked well for the fund over the long haul. Since its November 1994 inception, the fund's rolling five-year returns have been in the top quartile and above median 63% and 100% of the time, respectively. These steady results have translated into a 15% annualized return for the past 13 years, which is tops in the category. While short-term results have suffered, we think management can get things back on track.

OF NOTE

- Among the other resource stocks that the portfolio holds are EnCana Corp. (5.6%) and Canadian Oil Sands Trust (2.7%), which are industry leaders in natural gas and oil sands, respectively.
- There was disparity in performance within the fund's financial names, with the Bank of Montreal and CIBC significantly underperforming their peers. Management has been reducing positions in these two banks, but much of the damage to the stock prices was already done.
- The fund's stated benchmark is the S&P/TSX Capped Equity Index. Management chose it because it felt the income trusts in the S&P/TSX Composite Index distort the yield that the fund needs to exceed. But given that the fund has close to 9% in trusts, we think the Composite Index is a better yardstick.
- The fund's 2.01% management-expense ratio is lower than that of 66% of its peers.

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