The Dividend Value Discipline™
Market Commentary
3rd Quarter 2010

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Not surprisingly, The Dividend Value Discipline™ objectives remain unchanged: income every month, an acquisition process where you buy only those securities which become attractive on a "go forward" basis, and absolute returns of 8% each and every year.

The third quarter of 2010 ended with a new (post-2008 bear market) month-end high for the S&P/TSX Composite Index, and accounts that have been in the program for at least one year clocked in with returns in the 7-10% range on a year-to-date basis…yes, we are going to do our best to improve that number – we have a self interest in doing so. Of course, individual results will vary depending on when you joined the program and whether or not you started with cash or an exiting portfolio. Your personal results can be found on The Progress Monitor, which is within your reporting package.

I ended last quarter's market commentary with this missive: …*we are expecting a "grinder" of a summer, with lots of volatility. Our main focus is to use the volatility to our advantage and hold onto the gains thus far. Towards fall, I expect there will be a plethora of great value propositions, along with improved investor demand. For us, it takes both to make a great investment*…and that is pretty much the way it turned out.

Buy from the fearful and sell to the fearless was the strategy employed over the summer. Early on we were amazed at some of the prices we were offered for our corporate bond positions (fearless buyers)…and admittedly even more amazed when those prices went higher after we sold! Then, on August 26th, we were handed a big bouquet of roses, when the American Association of Individual Investors reported that only 21% of its polled investors were bullish – numbers not seen since March of 2009, i.e. the bottom of the bear market. It was at that point, where we felt compelled to "buy from the fearful" and I am happy to report, with good results.

In terms of the major sell decisions, in early July we eliminated our Sherritt International bonds over concerns of what then looked like a softening economy. The result was a positive one for the program, and yet there is no question that we would have been better off holding those bonds – we could sell them for more today. What we underestimated was the market's tremendous appetite for yield.

Learning from our mistakes, we held out for more and got it when we sold our Rona bonds on August 10th. Our rationale: the price offered to us was just too good to pass up, especially in light of the weaker Canadian housing data we were seeing. It was a net positive for the program and this time, there was no seller's remorse.

Next was the difficult decision to sell our stake in engineering consulting company Genivar, a fine company and certainly one that is friendly towards shareholders. That said, job #1 is to protect our clients from the downside, and Genivar's key leading indicator (its backlog), had started to wane and profit margins were also under pressure. All in, this investment was another positive one to the program.

So what did we do with the cash? In late July, with the natural gas market looking like it was picking up, we made the decision to stick our toes in the water with a small position of EnCana. A sustained improvement in the natural gas market has not materialized as of yet, and in the last hours of the quarter, we sold our shares, recording a small loss. We now believe we can better employ that capital in the likes of Husky, which we started acquiring towards the end of August and added to during the last week of September. We are attracted to the almost 5% dividend, and yet Husky has a very strong balance sheet and is conservatively managed. They also intend to spin out their Asian assets which we see as a potential catalyst to drive up the stock price. Insiders have been buying in scale, purchasing some $54 million worth of shares over a recent two week period.

In late August, with fear so thick you could cut it with a knife, it was time to move the offensive team onto the field. We started with a swap of our interest in disposable medical supplies provider Becton Dickinson for an equivalent position in 3M. The first thing to note with this trade is that Becton is in what we call a defensive space – whereas 3M is a much more cyclical company – with fear running at extremes, shares of companies like Becton tend to stand up far better than ones such as 3M. Paradoxically, my rationale told me that in terms of a trade, this is as good as it gets. Here is what we saw that tipped the scale in 3M's favour. It is one of the most innovative companies in the world where earnings results have already turned the post recession corner. Two thirds of its revenues are from outside the U.S., and 30% come directly from emerging markets. The company has rewarded shareholders with 52 consecutive annual increases in its dividend per share – we like that!

Also in late August, we purchased an initial position in IBM. "Big Blue" (as it is commonly known) has a culture of excellence, and we are culture company biased investors. Senior management has typically been with the company for 30 years and has been repeatedly promoted from within. Over three quarters of its revenues are recurring, which are the very best kind. Over 64% of their revenue comes from outside the U.S., with a big focus on the emerging markets. The value proposition looks extraordinary – at the time of purchase, IBM's forward looking earnings yield was just shy of 10%, and those earnings have been growing at double digit rates. In fact, they grew right through the recession. We get paid a decent 2% dividend, and that dividend has grown by some 16% per year over the last ten years. Senior managers appear to share our outlook as they have increased their stake in the company by almost 30% over the last 12 months.

In late August and early September, we took an initial position in nuclear power producer Exelon. This company is the largest nuclear plant operator in the U.S. and as such, it has a minimal carbon foot print relative to coal and/or natural gas. It also has two significant competitive advantages. The first one is barriers to entry – nuclear plants take a tremendous amount of capital and they can take up to a decade to build. Bottom line, the price of entry is huge which tends to keep competitors at bay. The second advantage is its low variable costs relative to competing power producers. Exelon's financial performance has improved as of late, and we expect that to continue as electrical demand slowly recovers and proposed rate increases get approved. In the interim, we "get paid to wait" with its almost 5% dividend.

Towards the end of September we sold insurance broker Arthur J. Gallagher (AJG), where our rationale was centred on opportunity cost. Although the investment in AJG has been profitable and we are confident that it is worth significantly more, the market simply isn't agreeing with us. Perhaps investors see AJG as an underwriter similar to Manulife and/or Sun Life (which it is not), and thus the apparent weakness.

In the final hours of the quarter, we closed out our minimal position of Progress Energy debentures (sold over the period August 24th to September 30th), over liquidity concerns and the fact that we see a lot more downside than upside at this point. This investment was another net positive contribution to the program.

Looking ahead, I do expect some turbulence in October. My read is that most money managers are behind the eight ball performance wise, and that the late August/September rally caught them by surprise. A lot of money was "chasing performance" into the final hours of last quarter. That pressure evaporates on October 1. We must also remember that as far as U.S. mutual funds are concerned, their tax year-end date is October 31. That means tax-loss selling season starts now. We are looking for beautiful babies being thrown out with the bath water. Bigger picture, the economy is stronger than most of us think – leading indicators have turned the corner and are heading north. Investors are starved for income alternatives and will be pushing dividend paying stocks to the upside. Post-October, we enter the seasonally strongest period of the year for the equity markets, November through April.

Yours truly,

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