The Dividend Value Discipline™ Market Commentary 1st Quarter 2012 (Q1)

As we close out the first quarter of 2012 (Q1/2012), the first question that comes to mind is, what happened to all the volatility? For example, in Q4/2011 we saw the S&P 500 put in 15 trading days where the blue chip index fell more than 1%, and there were 7 days where it fell more than 2%. The comparable numbers for Q1/2012 are 1 day that fell more than 1% and 0 days that fell more than 2%. In other words, we have witnessed an almost 180 degree turn around in market behaviour. Consequently, our strategy is morphing from "buy the panic and sell when you feel less bad" to "buy incrementally on any kind of pullback" and, to be candid, some of what we really want to own just keeps going up! Is the market over bought? Yes. Can it stay that way? Yes – in fact it has done so since the end of December. Valuation wise, in most circumstances we are still seeing better values in the US than Canada. Notwithstanding the overbought nature of the equity markets, significant opportunities still exist – it is just hard getting used to the lack of selloffs and thus more "decisive" buying opportunities.

This major change in market dynamic has made performance numbers for new entrants to the program challenging. While returns were still generally positive, new accounts, where we buy only what becomes attractive on a go forward basis, have lagged behind our fully invested accounts. The latter pegged in with returns in the +4% range on a year to date basis. While frustrating for all concerned in the short term, we continue to believe that the "buys only" approach is the path to reaching our objectives for The Dividend Value Discipline™: (1) income every month; (2) buy only those securities which become attractive on a go forward basis; and (3) +8% net returns each and every year.

As per our usual course, your individual results can be found on The Progress Monitor, which is included in your quarterly reporting package. What follows, are the program's major buy/sell decisions over the past quarter and the rationale for them:

Starting with the sells, in early February, we exited our Franco-Nevada Corporation position. Although we are fans of the company's predominately gold based royalty business model and its management team, the share price rose to a level where we no longer found the value proposition compelling. All in, we pegged a near 60% gain for our 37-month hold period.

On that same day (and a lot less rosy) we also eliminated nuclear power producer, Exelon Corporation, on the basis of underperformance. Its financial results have been lackluster and we couldn't see any catalyst that was going to move the stock. In short, our expectations failed to materialize, so we took a nominal loss of just over 1% for an 18 month hold and moved on.

Late in the month we eliminated our Provident Energy Convertible "F" Debentures position. The sell decision was driven by valuation concerns. Post our purchase late last year, Provident Energy announced a deal whereby it was being acquired by Pembina Pipeline, and on that announcement the price of the debentures jumped to a level where we couldn't see much further upside. Accordingly, we exited locking in a +8% gain for a short 3½ month hold period.

In March, we sold off our final position of Nucor Corporation at US$44.39 per share, taking a nominal loss of 2.68%. The sell decision was driven by the weak outlook for the steel industry and Nucor's uninspiring guidance for the balance of the year.

Turning to new acquisitions, our first purchase of the quarter was one of the world's largest copper producers, Southern Copper Inc., which is headquartered in Phoenix AZ. Southern Copper's leadership in low cost production amongst its global peers is what attracted us at the outset. Including by-product credits from finding other metals, its cash costs for producing copper in 2011 was a mere $0.41/lb. versus an average selling price of some $4.00/lb. Couple that cost advantage with a shareholder focused management group and the resulting earnings growth over the last decade has been some 39% per annum. The dividend growth rate over the same period is even better at +43%.

In mid-February we finally secured a big enough weighting in Anderson Energy Debentures to actually report on it. We started acquiring the A and B-series debentures in October 2011. They were deeply undervalued as few investors were aware of the changing story at Anderson, which was long known as a pure-play in the natural gas space. The reality is that

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the company is well along its path to becoming a balanced oil and gas producer, which translates to a huge shift in profitability. Since our initial acquisitions, the market has woken up to the inherent value and the price has marched steadily north. We now sit back and collect our +7% coupon and wait for the rest of the movie to play out – we expect it to end well and may even get a lift from a possible take-out.

In the last days of the quarter, we secured an initial position in energy fracture service provider, Calfrac Well Services Ltd. While the boom in "hydraulic fracturing" is well known, one of the attractions with Calfrac is the alignment of management incentives with shareholders (us). By way of example, its annual cash bonus program is a function of return on capital. This ensures capital is only invested in highly profitable projects, and if those are limited, then the company's cash is returned to shareholder, via dividends. This "capital discipline" has just been demonstrated with Calfrac's recent +400% dividend increase, an eye popping number for sure, but one we see as fully sustainable given it is only a fraction of its earnings.

Our final move of the quarter was an initial stake in an innovative fluid handling systems provider to the oil and gas industry, Poseidon Concepts Corporation. Poseidon solutions reduce the environmental impact and overall costs. Savings to its customers of approximately 35% in the summers and approximately 65% in the winters are the norm. Although imitators are hot on their tail, Poseidon has first mover advantage, allowing them to ramp up revenue by expanding its fleet. Profits have followed as fixed and variable costs are fairly low and its capital requirements modest. This has allowed the company to pay a substantial dividend. We also like the fact that senior executives and other insiders own almost $90 million worth of common shares or approximately 7% of common shares outstanding, which aligns their incentives with shareholders.

Of note regarding the purchases of Calfrac and Poseidon, is how these purchase decisions play to North America's rapidly changing energy production mix. I spoke to this theme on the latest edition of The Opportunity Update recorded on March 5, 2012. In short, US oil production is growing at double digit increases after spending the previous decade actually shrinking. The reason? Hydraulic fracturing in combination with the horizontal drill process has made shale oil extremely lucrative and shale oil beds like the Bakken are both numerous and massive. Both Calfrac and Poseidon are industry leaders with their own niche in helping energy companies exploit this previously useless resource.

Looking ahead, we are still predisposed to owning more dividend paying technology stocks as we see tremendous value in that space. It is apparent that other market participants are seeing it the same way – this is one group that "just doesn't want to let us in", i.e. pullbacks have been shallow and brief – hopefully, we will get our chance.

Other observations I have noted recently: the Asian markets continue to put in a series of lower lows and lower highs, classic bear market behaviour whereas the US markets are exhibiting the exact opposite – higher highs and higher lows – classic bull market behaviour. If the evidence changes we will change. In the meantime we are working hard to protect your capital (and ours) while we drive towards our ten year anniversary for The Dividend Value Discipline™, intent on delivering the above noted objectives.

Yours truly,

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