The Dividend Value Discipline™
Market Commentary
4th Quarter 2011 (Q4)

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2011 goes out as the most volatile year on record, which was especially true in the second half where over half of the trading days saw the S&P 500 Index move more than 1% in a single day – and yes, it seemed most of those days were down! When it was all said and done, the S&P/TSX Composite Index pegged a -11.1% return for the year and the S&P 500 Index came in a bit stronger at 0% (+2.2% in CDN$ terms). Our objectives for **The Dividend Value Discipline™** remained unchanged: (1) income every month; (2) new entrants (as well as lump sum deposits) to the program buy only those securities which become attractive on a go forward basis; and (3) a +8% net return each and every year.

So how did we stack up? Fully invested registered accounts (RRSP, RESP & RRIF) met or exceeded the +8% bogey, whereas non-registered accounts pegged in at a respectable +5%, on average. This major discrepancy in return figures is due to the tax motivated sale of our Stoneham Drilling position in late 2010 to buy Ensign Energy Services. Although I believed it was the right thing to do at the time, it is now abundantly clear that we "let the tax tail wag the dog." Your individual results can be found on **The Progress Monitor**, which is included in your year-end report. The **"buys only"** approach and different start dates means that no two account performance results are exactly alike.

How did we manage such outsized gains versus the negative return of the S&P/TSX Composite Index? First, I would point to the lessons learned and the systems put in place as a result of the bear market of 2008/2009. Looking back over the year, focusing on the discipline of relative strength allowed us to identify three major trend changes, that when acted upon, put the wind at our backs. We were early with our recognition that money was flowing out of the emerging markets, and that caused us to back off of our commodity producer positions. Next was the surprising strength of the U.S. dollar, and the world's renewed interest for large cap U.S. multinationals. Finally, the historical perspective on volatility within a sideways market encouraged us to tweak our trading strategy. Selling during euphoria and buying during panic seemed to be the only way to make money. In baseball parlance, we concentrated on base hits as opposed to home runs. Additionally, our great company bias allowed us to identify a couple of gems – namely, Herbalife and Nu Skin. I would also be remiss if I didn't also acknowledge the hard work of our analyst, Howard Ma.

What follows, are the program's major buy/sell decisions over the past quarter and the rationale thereof:

In early October we bought low cost, high growth gold producer **Alamos Gold Inc.** Due to Alamos' focus on cost-effective projects they report abnormally high returns on capital and have recently boosted their dividend by 40%. Our read is that there is more to come.

Shortly after, we eliminated our final position of aluminium producer **Alcoa Inc.**, locking in an overall gain of 13% for an 18-month hold period. We started selling Alcoa in May at just north of $17 per share (very near its 52-week high), and then sold more in July at just north of $16, leaving a 1% weighting. In hindsight, we should have sold them all, as the shares set a new 52-week low of $8.45 on October 4th. We exited on the next strong rally at $10.34.

As the market rallied in October, we became increasingly defensive as was illustrated with our purchase of three bond exchange traded funds (ETF's). Our strategy here was to use these vehicles as parking spots until we could secure better fixed income opportunities.

When we resumed shopping, we returned to a familiar company, namely leading farm equipment manufacturer **Ag Growth International Inc.** Rather than buying the company's shares, this time we purchased its convertible debentures. These instruments have two components: the income/return of capital and the stock option. We see the former as very secure, and the income yield on this is just north of 6%. The stock option component provides us with capital gain potential. We also purchased the convertible debentures of an energy producer and a pipeline company – for now they shall remain nameless as we are in the process of acquiring larger positions.

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In late October, we eliminated **3M Company**, with a nominal loss of 3.8% over a 14-month hold period. 3M remains a great company. That said, they have reported lacklustre results two quarters in a row.

In mid-November, we returned to consumer products company **Colgate Palmolive Co.** Its global reach and emerging markets exposure has translated into steadily improving profit margins. Colgate also has a history of excellent earnings quality and consistent free cash flow. Over the past decade, it has grown its dividend per share by more than 12% annually.

In December, we eliminated our position in **Ensign Energy Services Inc.**, at just shy of $17.00 per share to book a 12% gain over a 12-month hold period. The sell decision was triggered by my cautious tone on the oil complex. In essence, there was money on the table and I was convinced that the odds of buying it cheaper were pretty good. On the same day, we also exited our **Telus Corp.** bond position, as we just couldn't see the returns getting much better. This time we realized a gain just shy of 10% over a 12-month hold period.

Our last purchase of the quarter was semiconductor chip maker company **Intel Corp**. The Intel advantage is scale – being the largest in the business, cost advantages have translated into cutting edge technology envied by its peers. Annual earnings per share have grown at 28% annually over the past decade, which has translated into dividend per share growth of over 25% for the same time period. Our take is that its dividend will continue to grow.

As you may have heard on the latest edition of **The Opportunity Update** (our quarterly audio production), I expect the next ten years to be second best of my career and the ten years after that to be the best of my career. Why? In part, that is what history tells me to expect, i.e. when you come out of a severe bear market like 2008/09, you get an initial bounce and then a period of years where the markets move sideways, often in a volatile fashion. To do well, you must be prepared to move against the volatility and focus on dividend paying stocks. **The Dividend Value Discipline™** is in the right place at the right time. After years of sideways markets, you eventually break out to a new bull market as secular problems get fixed – that will be the best ten years of my career.

Aside from history, here are three key points that collectively make the outlook very encouraging:

1. Bonds (the alternatives to stocks) are more expensive today than they have been in my lifetime – on November 23/11, the 30-year Government of Canada bond closed at a record low yield of 2.63%. With interest rates so low, our take is that more people will look to invest in dividend-paying stocks – in essence, taking on a bit more risk in order to try to earn a higher return.

2. Ask yourself, how much more bad news is there to come? We are getting through the U.S. housing crisis, and our southern cousins are also begrudgingly recognizing their sovereign debt problem. History tells us that when something has to be done, it will get done – think back to how unflinching the Reagan years were. Furthermore, the European issues are on the table and well known.

3. Finally, investor psychology is at a very low ebb – you can cut the fear with a knife.

Suffice to say, I am looking forward to the next 20 years and I hope you are too.

Happy New Year,

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