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Cambridge dividend funds update

Stephen Groff, November 9, 2018

Despite a relatively unremarkable year in terms of market returns to date (+4% for the S&P 500 Index; -4% for the S&P/TSX Composite), it's been an interesting journey. Here's an update on some of the things we've been working on over the last few months.

It is important to note our portfolios have historically and will continue to be constructed using bottom-up fundamental analysis on a company by company basis. We had no unique insight on how 2018 would shape up, nor can we predict exactly where markets are headed over the short term. What we are certain about is our rigorous process: We continue to adapt the portfolios to the market reality by investing in high-quality companies trading at attractive valuations, while working to minimize risk.

We started 2018 with cash levels across the Cambridge Dividend Suite ranging from about 17% in Cambridge Canadian Dividend Fund to 23% in Cambridge Global Dividend Fund. This defensive posture was a result of a lack of suitable investment opportunities at a price we were comfortable with. In hindsight, holding high levels of cash has had an opportunity cost over the past few years. Our intention is that as the team and our idea-generation capacity continue to expand, we will find appropriate opportunities to keep the portfolios increasingly invested, absent valuation extremes.

For the early part of 2018, markets continued their relentless march upward and attractively valued opportunities were more challenging to come by. This began to change in February as equity volatility increased and pockets of the market quickly de-rated. During this time, a few quality defensive businesses, particularly in interest rate-sensitive sectors, quickly fell to prices where we saw limited fundamental downside. Examples include Verizon, Emera and Fortis. During this period, we were able to deploy material capital across the portfolios (over $900 million invested in the first 60 days of the year) and believe these positions can compound at attractive rates for you for years to come.

As the year continued, equity markets overall climbed higher, led by the U.S. This period was good for many of our more cyclical investments, while our more defensive holdings provided reasonable, but uninspiring performance. It would not take long for this market trend to reverse.

In October, volatility and sector dispersion began to materially increase. It was during this time that companies with certain attributes (elevated leverage, high valuations, cyclical, exposed to emerging markets) were sold with little discretion. Given the nature of the businesses held across the Cambridge Dividend Suite, many of our positions held up well – keeping in mind it was these same characteristics that the market found unattractive in more risk-on periods such as through much of 2017.

So what is Cambridge doing today given the market dislocation? The team is as busy as ever applying our consistent investment process which we have used throughout many market environments. We apply a rigorous, bottom-up process to construct and optimize portfolios. While we have our coverage list of quality businesses that are monitored, the price these businesses are valued at can change substantially depending on Mr. market's mood – creating both opportunities to increase or decrease position sizes when prices become dislocated from intrinsic value one way or another.

Today we are finding some of the best opportunities within spaces that many investors are quick to dismiss for several reasons. Below are two examples in which Cambridge has increased ownership of stocks as the risk/reward profile has improved. In both cases, we recognized the company's strong underlying fundamentals and continued weakness in the share price.

Crown Holdings (NYSE:CCK)
Crown operates a simple, but profitable business that manufactures packaging, primarily cans, across different end markets globally. It operates within an oligopolistic industry and has good supply discipline, modest but steady growth globally, attractive returns on invested capital and strong free cash flow generation. This year several factors have caused CCK shares to materially underperform and offer what we believe is a very attractive opportunity for longer-term investors. Despite CCK's excellent long-term track record of allocating capital at attractive rates of return, investors reacted negatively to CCK's acquisition of Signode Industrial Group, which makes strap, stretch and protective packaging used in shipment of goods. The share price fell on investor concern about the business being non-core, the increased leverage (as management wanted to avoid issuing shares), and exposure to markets considered to be more cyclical. After numerous meetings with management and industry checks, we believe the business has many similar characteristics and was a prudent use of shareholder capital.

As the year progressed, there were other issues that arose for CCK. The business has material operations outside of the U.S., including many emerging markets such as Turkey and Thailand. As EM currencies depreciated and many of these markets faced economic weakness, investors became concerned about the impact this would have on CCK's earnings – a concern amplified by its current elevated leverage.

We have continued to review our assumptions about the business and how it performs under various scenarios (*thanks to Analyst Authi Seevaratnam for the great work here*). However, we believe CCK can manage these issues given the structure of contracts and CCK's debt, market dynamics, strong free cash flow generation and end market diversification. The shares remain attractively valued and are owned across several Cambridge portfolios.

Vermillion Energy (TSX:VET)
Mention the words "Canadian energy" and one is quick to get several reasons why the space is all but investable. Yes, there are material differentials for different grades of Canadian crude oil. Yes, moving product out of the Western Canadian Sedimentary Basin (WCSB) is challenging and/or costly at present. Yes, many energy management teams are poor at allocating capital effectively, often pursuing a strategy of growth without enough focus on returns. That all being said, we believe there are still some good investment opportunities when one rolls up their sleeves and parses through this very unloved space.

Vermillion is a business we own and believe in for several reasons. Most importantly, management allocates capital based on where it can earn the high rates of risk-adjusted returns using prudent assumptions. It is far more concerned with production per share versus simply production – a subtle but important difference. The company's operations are located around the world, providing the opportunity to shift and focus investment to where returns are the most attractive. It has also been able to take advantage of market dislocations, acquiring Spartan Energy in April 2018 at an attractive valuation. Also, Spartan's output doesn't expose Vermillion to the wide differentials plaguing much of the WCSB. Vermillion's geographic and product diversity results in the business benefitting from exposure to higher-priced end markets such as Brent crude oil, light sour blend (LSB) and European gas.

Moreover, Vermillion's operating and financial profile is what enables the business to pay an attractive and growing dividend (now offering a 9% yield) backed by a reasonable payout ratio that offers the flexibility to continue to invest in high-returning projects. We have respect for the company's strategy, capital allocation plan, philosophy of operating responsibly and execution. We have also had encouraging discussions with management on how other tools such as share buybacks at attractive prices can be a good use of capital.

While market volatility can be challenging for clients, it is always important to remember that during these times, the seeds for future value creation are planted. The Cambridge team remains busy turning over new rocks and reexamining our existing rock collection to build what we believe are the best portfolios for compounding client capital over the long term.

Thank you for your continued support.

Stephen Groff

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IMPORTANT INFORMATION

Stephen Groff is a Portfolio Manager to some of the Cambridge funds. He has no material interest in the securities discussed herein; however, he is an investor in certain Cambridge funds that hold these securities.

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