Navigating Inflationary Times with Dividend Stocks

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Funds managed:
IA Clarington Canadian Dividend Fund
IA Clarington Dividend Growth Class
IA Clarington Dividend Growth GIF
IA Clarington U.S. Dividend Growth Fund
IA Clarington U.S. Dividend Growth GIF

What are the key opportunities and risks?

- There are currently two main risks to the economy: interest rates and inflation.
- There is a lot of concern in the market around when inflation will peak and where interest rates and inflation will settle.
- If inflation remains high, rates will continue to rise, which may push the economy into a recession.
- The economy has slowed from previous levels, but at this point our view is that if we do have a recession, it will be fairly mild as employment levels remain very strong compared to other periods where we had a slowing economy.
- We're finding opportunities across sectors and believe it's a great time to be an active manager.

Do you believe Canadian equities will outperform U.S. stocks?

- We think the outperformance we're seeing in Canada can continue for some time. Historically, these types of market rotations tend to have staying power.
- We're only 2–3 quarters into the current rotation, so we think there's a lot of room for this trend to play out.
- The composition of the Canadian equity market – with its high weighting to financials, energy and materials – is well suited to an environment of higher interest rates and higher commodity prices.
    - o Outside of deep recessions, financials tend to do well when rates are rising, and of course energy and materials will benefit from high commodity prices.

S&P/TSX Composite Index Sector Weights

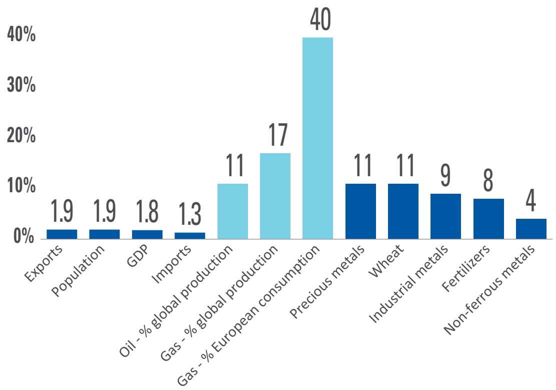
Sector	%
Financials	31.7
Energy	19.0
Materials	12.5
Industrials	11.2
Information technology	5.4
Communication services	5.1
Utilities	4.8
Consumer staples	4.0
Consumer discretionary	3.2
Real estate	2.7
Health care	0.4

Source: iA Investment Management, as at May 31, 2022.

- While energy prices have already outperformed materially, cash flow multiples are still at very low levels, which tells that us investors haven't fully bought into the idea that commodity prices are going to stay at higher levels for an extended period.
- Management teams of energy companies have made very positive changes from prior cycles and are now prioritizing the shareholder over production growth, which means less debt, more dividends and more share buybacks. It also means the sector is derisking, as balance sheets are in better shape than ever.

- The Russia-Ukraine conflict is also benefitting commodities. Russia is a small part of the global economy, but it controls a very large share of oil and gas production as well as food-related commodities.

Russia: A Major Exporter to World Markets



Source: IMF and Goldman Sachs Global Investment Research, as at May 31, 2022.

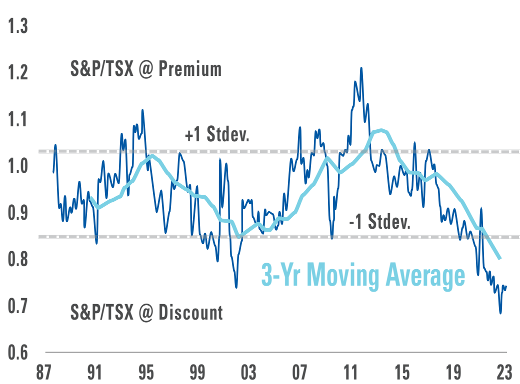
- The finance and commodities sectors make up over 60% of the S&P/TSX Composite Index, which we think positions Canadian equities very well on a relative basis.

What about valuations?

- The Canadian market is fairly inexpensive relative to historical levels. It's currently trading at a one-standard-deviation discount to the 30-year average.
- When we compare Canadian valuations to the U.S., the discount is even more stark, as Canada is trading at levels not seen in over 30 years. This is the reason why we have lowered the U.S. weighting in our Canadian mandate to only half its historical level.
- We think it's a great time to be focusing on Canadian dividend equities.

S&P/TSX Composite Index vs. S&P 500 Index

12-month forward relative price–earnings



Source: Scotiabank GBM Portfolio Strategy and Refinitiv, as at March 31, 2022.

How do dividend stocks perform during periods of rising inflation?

- In times of higher inflation and interest rates, multiples usually compress because investors place more value on current earnings and cash flows versus cash flows that will only come several years into the future.
- This environment favours lower-multiple and higher-dividend stocks, as returns are usually lower and dividend yield makes up a greater percentage of total returns.
  - o For instance, when we look at the 1970s and early 1980s, the period is similar to what we see today – high commodity prices, high inflation and high interest rates. Dividends made up 60% of the total return of the S&P 500 and 80% of the returns of the Canadian equity market.
  - o While we hope current conditions do not last much longer, we believe our mandates are positioned for this shift in the market, as we focus solely on divided-paying stocks with growth potential.

Calendar Year Performance & Dividend Yield During Recessionary Periods

S&P 500 Index	Price return	1969–1984 Total return	Dividend yield
Median	10.4%	6.2%	4.2%
Mean	9.1%	7.1%	4.2%
High	37.2%	14.6%	5.4%
Low	-26.5%	2.4%	2.7%
CAGR	3.1%	7.9%	
% of total return			60.3%
Toronto Stock Exchange 300 Index	**Price return**	**1969–1984 Total return**	**Dividend yield**
Median	0.4%	4.8%	4.8%
Mean	3.5%	8.2%	4.7%
High	32.3%	37.8%	6.2%
Low	-22.7%	-19.7%	3.0%
CAGR	1.6%	8.3%	
% of total return			80.9%

Dividend yield was 40-80% of total returns

Source: Bloomberg, FactSet and CIBC World Markets.
Toronto Stock Exchange 300 Index data for the 1944-1959 period starts in 1950.

Which sectors are you currently overweight in the Dividend Growth mandate?

- We've been overweight energy for the past nine months.
- Higher energy prices have helped the sector, but we are more excited about the changes in the way these companies are managed compared to prior cycles.
  - o In prior cycles where we saw higher energy prices, the focus was always on production growth. With cash flows being reinvested, companies were in poor financial shape once the next downturn in commodity prices took hold.

- o After a near-death experience in 2020, companies are now focused on paying down debt, growing dividends and even repurchasing their own shares.
- Even as oil and gas prices continue to rise, we are seeing no public companies break rank and materially grow production.
- We think the deleveraging taking place will make the sector less risky than before and could afford energy companies a higher multiple in the future.
- We are also overweight communication services. Companies in the sector were slow to recover from the Covid downturn as travel volume remained low and wireless data usage fell significantly. These are now tailwinds for the sector as the economy reopens.
- The sector also has high dividends with a long track record of growth. We feel this is a good area to have exposure to in this volatile market.
- Our overweight is based on positions in Rogers and Quebecor, where we see greater upside potential relative to peers.
  - o We think Rogers' acquisition of Shaw will be very accretive and that investors have not yet priced in the combined earnings power of both companies.
  - o With Quebecor, we think the company has a great opportunity to outgrow its peers as it grows its share of wireless usage in Quebec and expand its footprint across the country with the acquisition of Shaw's wireless assets.

IA Clarington Dividend Growth Class

Sector overweights relative to peers

	Fund	Peer Group
Materials	4.3	4.2
Consumer discretionary	3.2	4.5
Financials	32.3	37.0
Real estate	3.5	4.4
Communication services	8.6	7.6
Energy	17.3	16.1
Industrials	8.8	9.2
Information technology	4.4	3.6
Consumer staples	3.0	3.3
Health care	4.1	2.1
Utilities	7.3	8.1

Source: iA Investment Management and Morningstar.
Peer group is the Morningstar Canadian Dividend & Income Equity category. Data as at May 31, 2022.

Why are dividend funds a good option for investors?

- Historically, dividends have made up almost one-third of total returns in equities.
- If you think we're heading into a period of lower stock market returns, dividends become even more important. When you look back to the 1970s in Canada – a time of high commodity prices and high inflation – dividends made up about 80% of total returns.
- We believe there is no better way to keep up with inflation than to hold dividend stocks that will grow the income in your portfolio at rates that match current inflation and exceed inflation in most periods.

Visit iaclarington.com to learn more about the dividend funds managed by Donny Moss.

For definitions of technical terms, visit iaclarington.com/glossary or speak with your financial advisor.

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