

# Canada Income Pick List

## August 2012

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The Income Buy List continued its streak of strong performance in July, rising 3.8% versus a 0.5% total return for the S&P/TSX 60. The largest part of the strong performance can be attributed to **Bonavista Energy BNP** (up 15.3%), but **ARC Resources ARX** (up 9.3%) and **AGF Management AGFB** (up 8.0%) also helped. The stock that fell the most was **IGM Financial IGM**, and it only fell 1.9%.

In all, the Income Buy List has now posted a cumulative total return of 96.6% since its Jan. 1, 2009, inception, more than

double the 44.2% total return generated by the S&P/TSX 60 over the same timeframe.

Our model is recommending a couple of changes this month. First, we are adding **Nordion NDN** back to the Buy list, replacing ARC Resources. This past month, we published a new fair value estimate for ARC of \$23 per share, down \$4 from before. Combine this with the stock's rise in price, and ARC no longer trades at a discount to our current estimate of intrinsic value, rendering it ineligible for the Consider Buying

**The Morningstar Canada Income Pick List Strategy**  
The Morningstar Canada Income Pick List features our top dividend paying Canadian firms that we feel are stable and undervalued. These best ideas are further refined into a Consider Buying and a Consider Holding list.

### Canada Income Picks

| Company                              | Ticker | Sector               | Morningstar Rating | Current Price (CAD) | Fair Value (CAD) | Economic Moat™ | Uncertainty Rating | Market Cap (CAD Mil) | Dividend Yield (%) |
|--------------------------------------|--------|----------------------|--------------------|---------------------|------------------|----------------|--------------------|----------------------|--------------------|
| <b>Consider Buying</b>               |        |                      |                    |                     |                  |                |                    |                      |                    |
| AGF Management Limited               | AGFB   | Financial Services   | ★★★★               | 11.90               | 15.00            | Narrow         | High               | 1,143.84             | 9.08               |
| Bonavista Energy Corp                | BNP    | Energy               | ★★★★               | 18.23               | 24.00            | Narrow         | High               | 2,668.71             | 7.90               |
| Great-West Lifeco Inc.               | GWO    | Financial Services   | ★★★                | 21.68               | 23.00            | Narrow         | High               | 20,592.11            | 5.67               |
| IGM Financial Inc.                   | IGM    | Financial Services   | ★★★★               | 39.29               | 48.00            | Wide           | Medium             | 10,048.64            | 5.47               |
| BCE Inc                              | BCE    | Telecommunications   | ★★★                | 42.68               | 43.00            | Narrow         | Medium             | 33,028.59            | 5.08               |
| Shaw Communications, Inc. Class B    | SJR.B  | Media                | ★★★★               | 19.57               | 22.00            | Narrow         | Medium             | 8,651.97             | 4.96               |
| Thomson Reuters Corporation          | TRI    | Business Services    | ★★★★               | 28.44               | 39.00            | Narrow         | Medium             | 23,582.03            | 4.58               |
| ↑ Nordion, Inc.                      | NDN    | Healthcare Services  | ★★★                | 9.47                | 11.00            | Narrow         | High               | 586.95               | 4.33               |
| <b>Consider Holding</b>              |        |                      |                    |                     |                  |                |                    |                      |                    |
| Power Financial                      | PWF    | Financial Services   | ★★★★               | 24.72               | 30.00            | Narrow         | High               | 17,506.05            | 5.66               |
| Canadian Imperial Bank of Commerce   | CM     | Financial Services   | ★★★                | 73.35               | 76.00            | Narrow         | High               | 29,713.51            | 4.91               |
| Vermilion Energy, Inc.               | VET    | Energy               | ★★★                | 46.75               | 45.00            | Narrow         | High               | 4,527.20             | 4.88               |
| Bank of Montreal                     | BMO    | Financial Services   | ★★★                | 57.44               | 65.00            | Narrow         | High               | 37,141.71            | 4.87               |
| ↓ ARC Resources Ltd.                 | ARX    | Energy               | ★★★                | 25.03               | 23.00            | Narrow         | High               | 7,296.63             | 4.79               |
| Rogers Communications, Inc. Class B  | RCI.B  | Media                | ★★★★               | 39.31               | 45.00            | Narrow         | Medium             | 20,254.28            | 4.02               |
| TransCanada Corp                     | TRP    | Energy               | ★★★                | 45.67               | 44.00            | Narrow         | Low                | 32,172.74            | 3.85               |
| Peyto Exploration & Development Corp | PEY    | Energy               | ★★★★               | 21.40               | 30.00            | Narrow         | High               | 2,963.60             | 3.36               |
| TMX Group, Inc.                      | X      | Financial Services   | ★★★                | 49.50               | 50.00            | Narrow         | High               | 3,697.41             | 3.23               |
| Cenovus Energy, Inc.                 | CVE    | Energy               | ★★★★               | 30.65               | 42.00            | Narrow         | Medium             | 23,162.21            | 2.87               |
| Bombardier Inc                       | BBD.B  | Industrial Materials | ★★★★★              | 3.61                | 7.00             | Narrow         | High               | 6,333.05             | 2.77               |
| ↑ Enbridge, Inc.                     | ENB    | Energy               | ★★★★               | 41.03               | 46.00            | Wide           | Low                | 32,615.54            | 2.75               |
| Canadian National Railway Co         | CNR    | Business Services    | ★★★                | 88.47               | 80.00            | Narrow         | Medium             | 38,466.76            | 1.70               |
| Canadian Natural Resources Ltd       | CNQ    | Energy               | ★★★★★              | 27.35               | 51.00            | Narrow         | Medium             | 30,060.57            | 1.54               |
| <b>Consider Selling</b>              |        |                      |                    |                     |                  |                |                    |                      |                    |
| Encana Corp                          | ECA    | Energy               | ★★                 | 22.34               | 18.00            | Narrow         | High               | 16,448.94            | 3.59               |
| ↓ Canadian Pacific Railway Ltd       | CP     | Business Services    | ★★                 | 81.51               | 70.00            | Narrow         | Medium             | 13,993.76            | 1.72               |

All prices as of July 31, 2012. | ↑ = Upgrade, ↓ = Downgrade, \* = New Addition

The Income Consider Buying list is ranked by dividend yield. Note that our fundamental approach to evaluating stocks does not begin with yield.

We value companies based on a discounted cash flow approach to arrive at our fair value.

portion of this list.

Moreover, we are moving **Enbridge ENB** from the Sell portion of the list back up to the Hold portion, following an increase in the company’s fair value estimate to \$46 from \$37 per share, as well as an upgrade in its economic moat rating to wide. Finally, we are moving **Canadian Pacific CP** down to the Sell portion of the list, thanks to the stock rising to a point where it trades at a greater than 15% premium to its \$70 fair value estimate.

**Economic Moat**

Morningstar’s proprietary measure of the quantifiable, sustainable competitive advantage a company enjoys. All things held equal, we would expect a wide-moat firm to sustain relatively high returns on invested capital for longer than a narrow-moat firm and a narrow-moat firm to sustain relatively high returns on invested capital for longer than a no-moat company.

**Uncertainty Rating**

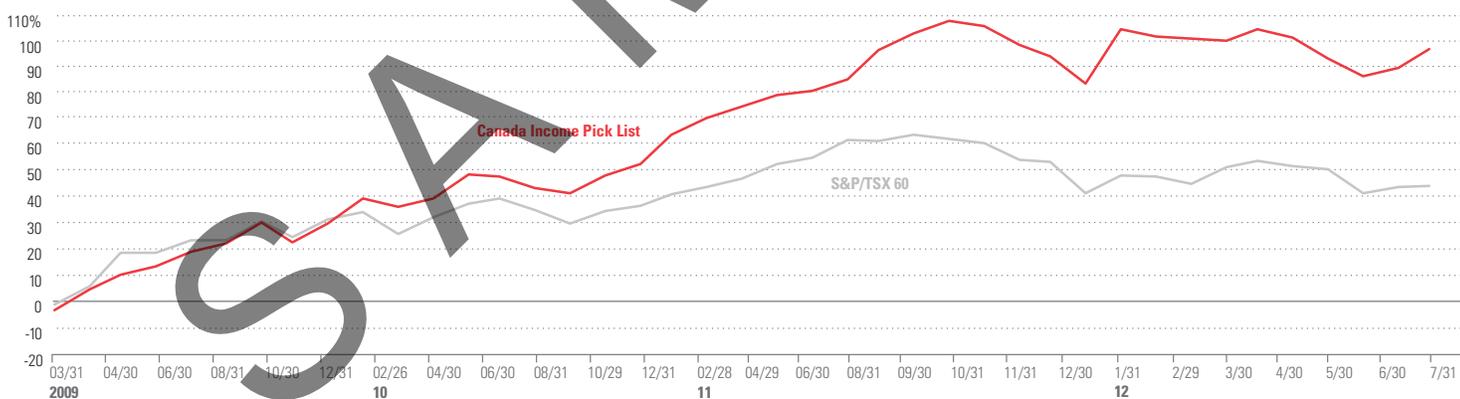
Morningstar’s proprietary measure of the degree to which the economic value of a company is uncertain. Three factors go into the uncertainty rating: revenue variability, operational leverage, and financial leverage. The greater each of these measures, the greater the difficulty in bounding the ranges of a fair value for the firm.

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| Performance vs. S&P/TSX 60 (%) | This Month | Trailing 12 Months | 2009 | 2010 | 2011 | Since Inception |
|--------------------------------|------------|--------------------|------|------|------|-----------------|
| Income Cons. Buying List       | 3.8        | -0.9               | 39.1 | 28.6 | 12.2 | 96.6            |
| S&P/TSX 60                     | 0.50       | -6.6               | 33.9 | 13.9 | -4.9 | 44.2            |

Inception: 1 Jan 2009

**Total Return: Canada Core Pick List vs. S&P/TSX 60 (%)**



## A Recap of the Stocks on This Month's Buying List

**AGF Management** remains on the list from last month, and our fair value estimate remains \$15. It is the highest-yielding stock on this list with a yield of 9.1%.

**Bonavista** was the best-performing stock on this list last month, but it still trades a significant discount to our \$24 fair value estimate. As a result, it remains on this list.

**Great-West Lifeco** remains on the list from last month after falling slightly in price relative to our unchanged \$23 fair value estimate.

**IGM Financial's** stock fell slightly in July relative to a steady \$48 fair value estimate. As such, IGM remains on the list from last month.

**BCE** remains on this list because of its 5.1% yield. That said, it trades at a very small discount to our \$43 fair value estimate, and a small amount of appreciation would make it ineligible for this list.

**Shaw Communications** remains on the list from last month, and our fair value estimate remains \$22.

**Thomson Reuters Corporation** remains on the list from last month. Beyond having a yield of 4.6%, it trades at a relatively large discount to our \$39 fair value estimate.

**Nordion** is being added back to the Consider Buy portion of the list. It has the smallest yield among these particular companies at just 4.3%.

**ARC Resources** is being dropped to the Hold portion of this list. A combination of a stock price that has risen and a fair value estimate that was cut by \$4 to \$23 means that the stock now trades at a slight premium to our new fair value estimate.

## An Overview of the Canada Income Pick List

The purpose of having a Consider Buy list and a Consider Hold list is to continually surface our best ideas in the Consider Buy list, while allowing users to track what's happened to former Consider Buy picks in the Consider Hold list. A Consider Buy list name "graduates" to the Consider Hold list once it is no longer among the top eight names based on our selection criteria, or once other fundamental factors have necessitated a change in our view of the company.

The Income Consider Buy list only includes Canadian companies with:

- ▶ Narrow or wide economic moats
- ▶ A fair value uncertainty that is not very high or extreme
- ▶ A price less than our fair value estimate (i.e. no overvalued companies)

We keep sector exposure for the Consider Buy list capped at 38%. Because we use an absolute rather than a relative approach to a valuation, there will be times that some sectors have greater representation in the Consider Buy list than others. This is especially true for Canadian stocks, which tend to be concentrated among a few major sectors like financials, energy, and basic materials.

## The Morningstar Methodology

The central tenet of the Morningstar approach to equity research is to buy strong businesses at appropriate margins of safety to what they're worth. This is what drives the star rating you'll find in each company report. A 5-star company is one we'd consider undervalued, meaning that its stock price is trading at a discount to its true worth that is greater than the margin of safety we'd need to consider buying it. A 1-star stock is, conversely, overvalued.

## Performance Tracking

Morningstar tracks the performance of the Core Consider Buy and the Income Consider Buy lists on a trailing month, year-to-date, and trailing year basis. As more time passes, we'll be able to add longer terms of measurement. To track performance, we began with a fictional \$100,000 invested equally in each stock on the buy lists. At the end of each month, we reinvest the value of the lists (including dividends) back into the new buy list, again with equal weighting.