cardinal UPDATE

AUGUST 2013

DIVIDEND INCREASES

Norfolk Southern	4.0%

(During the period: July 1 – 31, 2013)

RISK CONTROL – MAKING BAD NEWS GOOD NEWS

From reading our regular Newsletters, and by seeing the way we have our portfolios structured, most of you are likely aware that in recent years Cardinal has managed our portfolios around the risk of rising interest rates. With rates and yields artificially repressed by central banks in reaction to the crisis of 2008, the danger has always been – what will happen when rates start to be free to follow the market? Well, last quarter, the rest of the world caught up to us as Ben Bernanke pointed out that some tapering of the repression would be warranted as the economy improved. Now, despite that being a very obvious event which had to occur sometime, markets reacted like they had never even considered the possibility. Bond yields jumped dramatically. In Canada, the Government of Canada 5 and 10 year benchmark bond yields rose about 60% from 1.15% and 1.67% in early May to 1.87% and 2.55% in July. As Cardinal had feared, bond prices fell, REIT share prices fell and share prices of high-yielding interest-rate sensitive stocks, like utilities and pipelines, fell.

It was gratifying for Cardinal to have these events prove us correct. We succeeded in protecting clients from this risk. Our 6 month Canadian equity return was over 5% whereas the market was down 0.9%. All our balanced mandates were positive, whereas the bond index was down 1.7%. While yields have dropped back somewhat from their highs, we continue to expect yields to creep upwards over the next several months. The Federal Reserve has made it clear that they will act only as the economy can sustain itself, but as the economy strengthens the day gets closer when they will reduce Quantitative Easing. Cardinal will continue to avoid overvalued high-yield stocks and will keep our bonds in short duration. In the meantime, we are pleased to own Canadian banks and life insurance companies who will actually benefit from the higher yields. Even now, more Canadians are locking into higher rate fixed mortgages from lower-rate variable ones. This means extra revenue for the banks without a material increase in their costs. As well as paying out over 4% in dividends over the past few years, banks and lifecos are poised for capital gains if (when) yields rise. Sun Life has already seen its share price bounce 80% from $18 last fall, to over $33 now. We look forward to more.

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COMPANY FOCUS

TD BANK

TD Bank has a diversified array of operations that contribute to earnings. With earnings benefiting from rising interest rates, and friendly shareholder capital return policies, we continue to love the name as a core holding.

TD is the 9th largest bank in the U.S. ranked by deposits with profitable and growing operations spanning from northeastern U.S. down to Florida. TD's leading direct-to-consumer insurance business in Canada, its stake in leading U.S. online brokerage TD Ameritrade, and its wealth management operations all present excellent additional growth opportunities.

Recently management discussed the impact of rising interest rates on its business. A 0.25% increase in interest rates across the yield curve is expected to increase net interest income by $300 million per year, illustrating the upside the bank has to inevitably higher interest rates.

Since TD resumed raising its dividend at the end of 2010, the bank has raised its dividend twice each year and has increased its quarterly payout by 32% to $0.81 per share. With 7-10% annual EPS growth targeted and a payout ratio at the low-end of its target, increases to the dividend are expected to continue for the foreseeable future.

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