CAPSTONE CANADIAN EQUITY INCOME STRATEGY

Q3 Commentary

SEPTEMBER 30, 2024

AT A GLANCE

- Dividend-paying Canadian equities mandate
- Emphasis on larger, industry-leading companies with sustainable free cash flow
- Active management approach driven by thorough fundamental research
- $28 MM AUM

MARKET & STRATEGY UPDATE

The Capstone Canadian Equity Income Strategy ("CCEIS") had an outstanding third quarter in 2024, outperforming both its benchmarks. CCEIS delivered a return of +12.6%, surpassing the S&P/TSX Composite Total Return Index ("TSX Index") at +10.5% and the S&P/TSX Composite High Dividend Total Return Index ("TSX High Dividend Index") at +11.6%.

Since the end of the Great Recession, Canadian equity investors have become accustomed to fairly steady returns, albeit at a slower pace than the tech-driven U.S. market. From June 2010 to June 2024, the TSX Index achieved an annualized return of 8.0%, significantly lower than the S&P 500's 14.8% in USD terms. However, with central banks easing interest rates globally, investor focus has begun to shift away from high-growth tech stocks like NVIDIA toward interest rate-sensitive sectors that stand to benefit from the new environment. Canada's market, with its heavier weighting in banks and utilities, is positioned to outperform in this context, as evidenced by the TSX Index beating the S&P by 4.7% in Q3 – the second-largest outperformance in the last 14 years.

CCEIS benefited from a diversified range of performance contributors this quarter, particularly in the Consumer Discretionary, Communication Services, and Financials sectors.

The most significant contributor was Sleep Country Canada, which soared 34% following the announcement of its acquisition by Fairfax Financial Holdings on July 22. This marks the second consecutive quarter where M&A activity boosted our returns, as last quarter's performance was also helped by National Bank's acquisition of Canadian Western Bank. We have held Sleep Country in client portfolios since the inception of CCEIS, initially purchasing shares in October 2022 for $23. While we are pleased with the outcome, we are a bit disappointed to see the company leave the public markets, as we believe it was well-positioned for future growth amid a rebounding housing market.

During the quarter, we replaced Sleep Country with Martinrea International, a Tier 1 auto parts manufacturer headquartered in Vaughan, Ontario. Despite recent challenges like the pandemic and slower-than-expected electric vehicle adoption, Martinrea's current valuation presents an attractive opportunity. Trading at a forward P/E of under 5x and an EV/EBITDA multiple of around 3x, we see substantial upside potential, with the market underestimating the quality of Martinrea's business and its long-term growth catalysts.

The Communication Services sector also added value this quarter, led by Cogeco Communications, which posted a strong earnings result under its new CEO, Frédéric Perron. Following this, several analysts upgraded their outlooks for the stock, helping the stock to achieve a 40% total return, the highest in the sector.

In Financials, all of our stock picks saw double-digit gains, led by CI Financial, which returned 29%. CI reported solid Q2 results, driven by strong growth in assets under management, EBITDA, and earnings per share. Additionally, CI's aggressive share repurchase program, as well as a bond buyback at substantial discounts to par, added significant value for shareholders.

Year-to-date, CCEIS has delivered +20.7%, well ahead of both the TSX Index (+17.2%) and the TSX High Dividend Index (+14.8%). Despite this strong performance, we believe the portfolio still offers exceptional value in the current environment. We are optimistic about the portfolio's prospects as we head into the remainder of 2024 and into 2025.

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