Value managers find safety in consumer stocks: Sweeney and Arpin have sidestepped the resources stampede

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Illustration: Black & White Photo: Brennan O'Connor for National Post / Stephen Arpin, left, and Andrew Sweeney, managers of Beutel Goodman's Canadian Dividend Fund, look for strong cash flow and growing dividends or stock buybacks.

Value managers Andrew Sweeney and Stephen Arpin, both vice-presidents at Toronto-based money manager Beutel Goodman & Co. Ltd., are buying stocks of companies that are less sensitive to the global economic climate for their Canadian Dividend Fund.

Investors, says Sweeney, are chasing resource-based cyclical stocks that have been benefiting from strong commodity prices, reflecting demand from Asia.

The result is that stocks in sectors such as consumer staples and health care, which tend to be less economically sensitive, are out of vogue, he says, and are trading at valuation metrics that are, in some instances, "close to decade lows." This is particularly the case in the United States, says Arpin.

Beutel Goodman manages assets of $13.68-billion. Arpin, who has been with the firm for almost 13 years, recently joined Sweeney on the Canadian Dividend Fund. The two managers emphasize companies with a solid franchise that generate steady cash flow, and regularly enhance shareholder value.

The two managers will buy stocks they consider are trading at around two-thirds of the estimated intrinsic value of the company. The focus is on total return -- capital gains and dividends -- and the duo looks for a minimum total return of 50% over two to three years. It is key, says Sweeney, that the company is a strong cash flow generator and is using its capital and cash flow wisely.

These two managers like to see their target companies increasing dividends and/or buying back stock. "The stock must carry a dividend yield above that of the market as a whole," says Arpin.

Their portfolio has 31 names, so their holdings are fairly concentrated. Sweeney and Arpin have 5% of their fund in foreign stocks versus the mandated limited of 15% for this fund.

In keeping with their theme of focusing on less economically-sensitive stocks, a recent addition from the U.S. health-care segment is:

- Johnson & Johnson (JNJ/NYSE). Headquartered in New Brunswick, N.J., this company (market capitalization US$172-billion) is a major global manufacturer of health-care products serving the consumer, pharmaceutical and professional markets. It is a big producer of medical devices, says Sweeney.

"In a display of discipline in its use of capital, this company recently walked away from its initial bid for U.S. stent maker Guidant Corp. Johnson & Johnson considered that the going stock price for Guidant was high in the light of the target's challenges."

Guidant was, in the end, acquired by Boston Scientific Corp. at the beginning of this year.

Johnson & Johnson, says Arpin, has a great balance sheet and "significant" net cash. "We see these as important assets." While some financial analysts have expressed concern as to how Johnson & Johnson will deploy its capital and free cash flow, we consider that the company will be disciplined in its use."

The stock trades at 16 times consensus 2006 EPS estimates -- the low end of its P/E multiple trading range of 15 to 22 times over the past 62 years. Also, the company has been accelerating its rate of dividend growth. The stock currently offers a dividend yield of 2.3%.

Sweeney and Arpin have been increasing their weighting in Canadian-based publisher:

- Thomson Corp. (TOC/TSX), one of the world's largest providers of information in specialty fields. The Toronto-based company's main market groups are Thomson Legal and Regulatory and Thomson Scientific and Healthcare.

"The stock is out of favour," says Sweeney. "The company's pace of earnings growth has slowed, he says, "due to the amortization of intangibles related to recent acquisitions."

But, says Arpin, Thomson is a strong cash-flow generator and has consistently raised its dividend. The stock trades at 17.5 times estimated free cash flow per share for 2006. "This is an attractive valuation for this quality of business," says Sweeney.

The two managers have been realigning their holdings in the Canadian financial services sector. They have added to their holding in:

- Toronto-Dominion Bank (TD/TSX), which now constitutes 7.5% of their portfolio and is one of their major holdings.

"With the addition of Canada Trust, TD has become one of the largest retail banks in Canada, rivaling Royal Bank of Canada, and retail banking is lower risk than corporate banking," says Sweeney.

As well, the sale of its U.S. brokerage business to Ameritrade in exchange for a 32% interest in a new entity, TD Ameritrade, helped to surface value, he says. The stock carries a dividend yield of 2.7%.

In the Canadian life insurance segment, the two managers have added a new position in:

- Great-West Lifeco Inc. (GWO/TSX), a Winnipeg-based major life insurer and provider of financial products.

Great-West has seen its earnings growth rate come under pressure from the translation of its U.S. dollar-denominated earnings. But to Sweeney and Arpin, the company's balance sheet is structured in such as a way as to make it less sensitive to changes in financial markets, including interest rate changes, than its peers.

Also, says Arpin, the stock is trading at 13 times EPS estimates for 2006, "which is low compared to its historic multiple" and the stock carries a dividend yield of 3.1%.

Sweeney and Arpin have trimmed their significant holding in:

- Industrial Alliance Insurance and Financial Services Inc. (IAG/TSX) The stock of this Quebec-based insurer "reached our initial target price," says Arpin.

SPOTLIGHT:

JOHNSON & JOHNSON

Ticker: JNJ/NYSE

Closing Price US$58.22

52-week range US$69.99 - US$56.55

THOMSON CORP.

Ticker: TOC/TSX

Closing Price $43.74

52-week range $45.50 - $38.80

TORONTO-DOMINION BANK

Ticker: TD/TSX

Closing Price $65.36

52-week range $65.95 - $49.09

GREAT-WEST LIFECO INC.

Ticker: GWO/TSX

Closing Price $29.25

52-week range: $31.00 - $26.55

INDUSTRIAL ALLIANCE INSURANCE

Ticker: IAG/TSX

Closing Price $32.10

52-week range $32.79 - $26.55