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Don't Settle for Just Any Yield

"Canadian stocks have rallied to a record amid a resurgence in energy producers and gold mining shares," states a Bloomberg report. The S&P/TSX Composite Index has nearly doubled five years after closing at 7,567 on March 9, 2009. Alternatively, six years after a record high above 15,000 in June 2008, the TSX closed at an all-time high above 15,100 this week. A good portion of investors might be thinking - it's about time! Those who failed to participate in the early rally could be eager to do so now. To this we refer to economist John Kenneth Galbraith, who famously opined the financial memory is "notoriously short."

Attempting to assess global markets today is like going on a first date. Excitement over the possibility of things working out, but at the same time, anxiously trying to identify reasons to be cautious. For instance, the frequently cited CBOE Volatility S&P500 Index (VIX) is near its historic lows at 10.6. This suggests market fears have subsided at least in the near term. However, the Shiller cyclically adjusted price-to-earnings ratio of the S&P500 Index at 26.3x is well above its long run median of 15.9x. This indicates the market could be in line for a downward correction. In another example, this week the US core Consumer Price Index (CPI) rose 2.0% on a year-over-year basis, moving within the Fed's target inflation range and suggesting the world's largest economy is growing healthy. However, a fall in real average hourly earnings and a rise in the cost of shelter, both CPI components, indicate a more bumpy recovery could be ahead.

In regards to the improvement in CPI, general theory suggests interest rates should rise to control the pace of inflation. But it is still uncertain whether the US economy is on firm enough footing for policymakers to take bigger steps in tightening. The low for long environment has been a boon for debt financings, profit margins, and asset prices. Rising inflation and low nominal rates have historically been a great setting for equities with resource exposure. In terms of the energy sector, turmoil in the Middle East and lower crude inventories have pushed the benchmark WTI price above $105 per barrel. Canadian energy stocks have underperformed the global energy market over the past three years following a nearly decade long outperformance before the crisis. Due to lower valuations, these stocks seem better positioned to benefit from a possible energy rally. So while overall equity market yields continue to be pushed down by investor appetite, we can still find sectors with attractive yield, in various forms.

A yield measure we often look to in assessing the value of businesses is the free cash flow (FCF) yield, which is a company's cash flow from operations less its required spending, divided by its market capitalization. FCF is an important measure because it gives us a sense of the sustainable excess cash a business can generate to then drive shareholder value.

At Canadian Natural Resources' (CNQ) recent investor day presentation, President, Steve Laut, peppered the audience with the term FCF. CNQ has a five-year plan to execute towards sustainable FCF between $5.5 and $6.5 billion by 2018. On average, this equates to a FCF yield of 11.5% on the stock's current market cap of $52.3 billion. Supporting this valuation are existing operating assets and reserves that should generate at least 9.0% production growth annually over the next five years. CNQ has one of the strongest balance sheets among large cap energy businesses, and is widely viewed as a best in-class operator. The company has demonstrated its ability to execute on its FCF strategy, having increased its dividend per share for fourteen consecutive years. As a result, we are confident in CNQ's ability to continue compounding its book value, even through difficult times like 2009. QV currently holds CNQ at a top 6.0% weight across its Canadian Large Cap Equity and Balanced Fund mandates.

Not every resource business in Canada has the asset quality, management vision, or valuation of a CNQ. Market excitement around the IPOs of royalty companies has seen these FCF generating entities trade down to yields of 4.0%. Although there is more operating risk in owning a producer like CNQ, with so many mixed signals out in the market, we feel it is the lower risk approach to generating long run, outsized returns.