RussellResearch

Beutel, Goodman & Company Ltd.

TRADITIONAL VALUE CANADIAN EQUITY

Equity | Canada | Value | -

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Russell Investments

Beutel, Goodman & Company Ltd.

PRODUCT: TRADITIONAL VALUE CANADIAN EQUITY

ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Equity	Canada	Value	-

OVERALL EVALUATION

① ② ❸ ④
Retain

We recommend that clients retain this manager.

Updated By: Phil Chen
Target Excess Return: 75 to 150 bp
Target Tracking Error: 400 to 600 bp
Time Period: > 4 years
Russell-Assigned Benchmark: S&P/TSX Composite Index

DISCUSSION

We recommend that clients retain this manager.

We have high confidence in Mark Thomson, the team leader, and the process that he has in place; however, he is now supported by only four team members, which is fewer than in the past. We also view negatively that the firm has moved to a global research platform because this distracts the team from the Canadian products.

The value-added drivers of this product are Beutel Goodman's disciplined stock selection criteria and detailed fundamental research effort. We view Beutel Goodman's process favourably as they purchase companies below business value and focus their portfolios in companies that generate free cash flow and have consistent earnings patterns.

We expect this product to outperform the S&P/TSX Composite Index by 75 to 150 basis points per annum, over longer annualized time periods (i.e., in excess of four years). Based on the broad sector constraints and the concentration in approximately 35-45 holdings, we expect the associated tracking error to be in a range of 400 to 600 basis points.

INVESTMENT STAFF ① ② ❸ ④ ⑤

Mark Thomson is the team leader for the Traditional Value Canadian equity product and has been in this role since 2002; our opinion of Mark in this role is favourable. We view negatively that Andrew Sweeney left the firm in April 2007, given the fact that he had become a key decision maker and had above-average insight and knowledge.

LOW ① ② ③ ④ ⑤ HIGH

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James Black joined in May 2007; he spent twelve years on the sell side and also brings a new perspective to the team owing to his private equity experience. Nevertheless, as a result of our first meeting with James, we believe that he does not possess the same level of insights as Andrew in terms of stock research and also portfolio management.

There have been a number of other changes to the Traditional Value team. In 2008, KC Parker officially moved to the Global Equity team; KC was hired to replace Norm MacDonald who left the firm in late 2005. Although Bill Otton was presented as a career analyst in the past, he was promoted to co-manage the small cap portfolio in February 2007; as well, he remains the analyst for the Materials sector. As a result, staffing is a watch point because the net effect is that the Canadian team is smaller than it once was and there are no current plans for additional hires.

Nevertheless, compared to peers, we still believe that Beutel Goodman's investment team has good depth and breadth with seasoned key professionals. As well, there are few distractions from the investment process for the portfolio managers and analysts due to minimal client servicing responsibilities.

ORGANIZATIONAL ENVIRONMENT ① ② ❸ ④ ⑤

In April 2005, Affiliated Managers Group (AMG) acquired First Asset Management, which owned 49% of Beutel Goodman. Beutel Goodman retains complete control over its entire operations, with internal partners controlling 5/8ths of the voting rights at the firm. In addition, Beutel Goodman continues to have the first right of refusal in any sale of its shares

The 51% that Beutel Goodman owns is split between 34 partners. Overall, the firm has taken positive steps in terms of succession planning for both this product at the firm-wide level.

Following a long period of stability, there have been a number of staff changes since 2005 with the most notable being the departure of Andrew Sweeney in April 2007. We view this negatively given that Beutel Goodman has a history of being slow with new hires.

SECURITY SELECTION ① ② ③ ④ ❺

Beutel Goodman's stock selection process has evolved in recent years to incorporate a broader definition of value. The team has placed an increased consideration to factors such as a firm's ability to create long-term shareholder value through free cash flow generation or sustained earnings growth. In addition to discounted free cash flow analysis, Beutel Goodman will compare a stock's valuation against industry comparables using a variety of typical valuation measures such as P/B, P/E and Discount to Replacement Value. They also favour companies that pay dividends provided that they generate free cash flow. They believe a good dividend policy is a sign of good capital discipline. We believe this makes intuitive sense.

RESEARCH ① ② ③ ❹ ⑤

The firm's internal research capability is better than peers with portfolio managers/analysts who are sector specialists; however, we have some concerns that they are distracted by having global responsibilities. Research recommendations are supported by comprehensive research reports that must address minimum standards in terms of growth rates, profitability levels, balance sheet quality, and management effectiveness. Andrew Sweeney's departure from the team is significant given that we had a high opinion of his abilities and insights; nevertheless, we still believe that the vast majority of large and mid-cap stocks are afforded the proper amount of attention and that the team has sufficient depth and breadth of experience.

LOW ① ② ③ ④ ⑤ HIGH

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Research at the firm has moved to more of an integrated platform which means that the global team members are providing input to the Traditional Value product; as well, there is the impact that the Canadian Equity team members now also have global coverage. We will monitor the time demands on the Canadian team and we may also need to meet the global team members.

ASSET ALLOCATION ① ❷ ③ ④ ⑤

In unconstrained portfolios, the cash weight could go as high as 10%, which is down from their previous limit of 25%, but this is still too high in our opinion. Beutel Goodman has not demonstrated an ability to effectively time the use of cash in its fully discretionary mandates; in fact, cash drag has been a notable detractor lately so we strongly recommend that clients specify a fully invested portfolio with less than 5% cash. However, going forward, they will be more actively targeting to keep cash levels down around 2%.

SELL DECISION ① ② ③ ❹ ⑤

The team has recognized the need to be more responsive to deteriorating fundamentals with portfolio holdings, and has assigned a second analyst (usually Mark Thomson) to undertake a review of poor performing stocks in some cases. Beutel Goodman continuously monitors the fundamentals of all the stocks in the portfolio.

For each stock that reaches its target price, they automatically sell one-third of the position and then review the fundamentals immediately to establish a new target price; however, if they feel the stock is fully valued, then the remaining shares are sold. They have completed a review of their sell discipline for cyclical stocks which have a tendency to overshoot their target prices; while cyclical stocks will still be automatically trimmed at their target prices, during frothy markets, however, they will be allowed to appreciate to their calculated “irrational” prices before being trimmed again or sold.

For each stock that has not yet reached its target price, Beutel Goodman monitors for fundamentals deterioration and will sell if they feel that the stock will not reach its potential. We continue to believe that Beutel Goodman’s sell discipline is disciplined and responsive within their peer universe.

PORTFOLIO CONSTRUCTION ① ② ❸ ④ ⑤

Portfolios are created from bottom-up research resulting in large active industry-relative and stock-specific bets, fallouts from the firm’s valuation discipline. Allowable sector ranges are quite broad, which is not unusual for value managers. Beutel Goodman’s increased attention to benchmark relative bets is a positive development; however, fully discretionary portfolios will continue to deviate significantly from the S&P/TSX Composite Index.

We are encouraged by the evolution of Beutel Goodman’s analytical framework and we believe that their distinct expected return hurdle targets (50% for non-cyclical companies and 100% for cyclical companies) create a portfolio that is properly compensated for stock specific risk.

IMPLEMENTATION ① ② ❸ ④ ⑤

Mark is the final decision-maker for this product although he works very closely with other team members. Although stock ideas are subject to a review process by peers, we believe implementation is efficient given the low turnover of the portfolio.

LOW ① ② ③ ④ ⑤ HIGH

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The cap for assets under management for Canadian equities is set at 1% to 1.5% of the S&P/TSX Composite market capitalization, which we view as high for such a concentrated strategy. They were managing about $6.5 billion and believe they can manage a total of at least $11 billion in AUM; as assets approach this level, this will become a watch point for us.

LOW ① ② ③ ④ ⑤ HIGH

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PRODUCT: CANADIAN EQUITY

ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Equities	Canada	Value	-

Mid cap bias

USE OF INVESTMENT APPROACH

This strategy combines large to medium capitalization stocks with a pooled fund for small capitalization stocks consisting of a maximum weight of 20% of the portfolio.

Value philosophy supported by strong internal research

DISTINGUISHING BELIEFS/PRINCIPLES

Beutel Goodman believes that superior long-term investment results can be achieved through the consistent application of a value philosophy supported by a strong internal research capability.

The firm seeks well-managed companies with above-average growth and profit potential with an emphasis on free cash flow that can be purchased at reasonable prices in terms of price/earnings ratios, price-to-book ratios and discounts-to-asset values.

Attempt to add 2% p.a. over S&P/TSX Composite Index

INVESTMENT PHILOSOPHY/OBJECTIVES

The firm's expected performance objective is to exceed the S&P/TSX Composite Index by 200 basis points per annum over rolling four-year periods.

Two decision makers for large and small cap respectively

DECISION MAKING STRUCTURE

The Canadian equity team consists of seven investment professionals. Within this team, there are two small specialist teams that are ultimately responsible for the portfolio construction of the Canadian equity product. The large-medium cap team consists of Mark Thomson, Normal MacDonald, Andrew Sweeney, Bill Otton and Pat Palozzi. The small cap team consists of Stephen Arpin and Denis Marsh. Denis works on a part-time basis.

Mark Thomson makes final decisions on the large to medium capitalization component of the portfolio. Steve Arpin makes final decisions on the small capitalization component of the portfolio.

The entire Canadian equity team meets weekly to discuss developments and to consider the merits of specific investment recommendations. They believe that this process encourages objective analysis and supports an environment that will allow each professional to vigorously challenge investment ideas and recommendations.

Bottom-up process

INVESTMENT EMPHASIS

The bottom-up process is tempered by their economic outlook. This is particularly true with respect to those companies that have a more cyclical bias.

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Cash builds when the market is viewed as overvalued

ASSET ALLOCATION

Cash is used as a residual when stocks are determined to have become overvalued within the marketplace. The cash weight can be raised to as high as 15% on a typical portfolio. However, the normal range for cash is 2% - 9%.

Clients may request a 5% cash restriction.

Convertibles have been used as common stock equivalents where the premium on the convertible is not excessive.

Stock selection process drives weighting scheme

SECTOR/INDUSTRY WEIGHTINGS

Sector/Industry weightings are a residual of Beutel's investment process. The bottom-up stock selection process determines the weights allocated to each sector.

Sector weights are limited to the greater of:

- 10%;
- 2.5x the Index's sector weight to a maximum weight of 30%; and,
- For sectors above 30%, maximum weight is 1.1x sector weight.

There are no minimum sector weights.

Security constraints are:

- Maximum weight in the portfolio = 10%;
- Maximum float on positions = 10%; and,
- Stocks over 10% weight of S&P/TSX Index can be held 1.25x weight.

Universe consists of 150 large-medium cap stocks

SECURITY SELECTION PROCESS

The starting universe is the S&P/TSX Composite Index but the focus is on the roughly 150 large to medium capitalization companies with a market float greater than $600 million. They keep an extensive list of portfolio and non-portfolio stocks with upside price targets that are updated frequently. To be included in the portfolio, non-cyclical companies have a return objective of 50% while cyclicals require a 100% return over their two to three year time horizon. Detailed research and industry reports are a key part of their process.

A major emphasis on free cash flow generating companies.

SELECTION CRITERIA

The object of the research process is to identify high quality, liquid companies whose management has successfully built shareholder value over extended periods of time.

A common characteristic of these companies is their sustainability to generate free-cash flows, which provide the financial flexibility to support organic growth or profitability, make strategic acquisitions, buy-back shares and pay dividends. Future cash flow needs, not historical, are the main focus.

Extensive internal research

RESEARCH

Research recommendations are communicated through comprehensive written reports that must address minimum research standards in terms of growth rates, profitability levels, balance sheet quality and management effectiveness.

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Management interviews are a key part of their research.

Research activities for the large to medium capitalization component are divided by industry/sector group across six analysts/portfolio managers within their area of specialization:

Steve Arpin: Small Cap, Software, Food Retailers;

Norman MacDonald: Transportation, Oil & Gas, Capital Goods, Autos, Chemicals;

Denis Marsh: Small Cap, REITs, Biotechnology;

Bill Otton: Metals & Minerals, Golds, Printing, Forest Products, Steel & Fertilizer;

Pat Palozzi: Consumer Products;

Andrew Sweeney: Technology, Telecommunications, Investment Companies; and,

Mark Thomson: Banks, Insurance, Pipelines, Gas/Electrical Utilities.

Research files are maintained on each of the S&P/TSX companies, of which 125 are followed on an active basis. As well, they produce comprehensive industry reports that are updated regularly. Investment dealer generated research is used as a source of investment ideas and for statistical purposes.

Expected return over 2-3 years

VALUATION METHODOLOGY

For non-cyclical companies that have successfully built shareholder value, Beutel requires a stock purchase price, which represents a 50% discount from fair or intrinsic value over a 2-3 year time horizon. For all other companies, a 100% return is required to compensate for the added risk involved. The valuation characteristics that are focused most on are: price/cash, price/book, discount to replacement value and price/earnings.

Thorough review process

SELL DECISIONS

When a stock reaches it's target sell price, 1/3 of the position is sold. The analyst responsible for the issue must review in writing the original research recommendation; he must convince the group that the issue continues to have investment merit and establish a new price target. If the group is not convinced, then the remaining position is sold outright.

The same review process applies when a stock declines in price by 15% or developments suggest a change to the original thesis on which the purchase decision was based. Typically, a second analyst is assigned to review the fundamentals of the company.

Model portfolio includes small-cap pool

PORTFOLIO CONSTRUCTION

A fully diversified portfolio will typically include thirty-five to forty-five medium to large capitalization. 85% of the portfolio is in 25-30 stocks. Portfolio turnover would be approximately 20-30% per year.

The weights assigned to each individual issue will reflect either liquidity considerations or the judgement of the analyst with respect to growth rates, profitability levels, balance sheet quality, etc. The greater the degree of confidence and/or liquidity the higher the weighting.

A pooled fund for small capitalization Canadian stocks is used. The maximum small cap position in a Canadian equity portfolio would be 20%.

Although portfolio construction results from a bottom up stock selection process, portfolios will occasionally have a dominant theme.

New portfolios that are unconstrained in terms of investment policy are structured to comply with the model portfolio. Stocks would not be added where the difference between the current price and target sale price is less than 10%.

Portfolio managers adhere to model process

REVIEW AND CONTROL

A strict model process designed to ensure consistency across portfolios in terms of investment strategy and investment results is used. Portfolio managers are responsible for ensuring that their portfolios are in compliance with investment guidelines and consistent with the structure of the model portfolio in terms of individual issues and industry weights. To do this, portfolio managers receive a daily summary transaction report on the days trading for each of their portfolios and a weekly consistency report comparing each of their portfolios against the model.

Attempts are made to control costs

TRADING

Professionals responsible for this area include Irene Lau (large cap) and Craig Weisberg (small cap).

Orders are pro-rated across accounts.

Crossing networks are used where possible, with transfer prices based on the mid-market price or the price at which the greatest volume occurred.

Trading costs are closely monitored, controlled and evaluated.

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PRODUCTS REVIEWED

PRODUCT	ASSET CLASS	GEOGRAPHIC EMPHASIS	STYLE	SUBSTYLE
Canadian Small Cap Equity	Equity	Canada	Small Capitalization	-
Dividend Income	Equity	Canada	Income	Value
Traditional Value Canadian Equity	Equity	Canada	Value	-

MANAGER UPDATE

On August 27, 2008, Dan Furneaux, Kathleen Wylie and Phil Chen met with Mark Thomson, Steve Arpin and Dan O'Reilly of Beutel, Goodman & Company Ltd. (Beutel Goodman) to review a number of their Canadian equity mandates. The market environment has been an extreme headwind to value investors but we remain confident in Mark's investment abilities and leadership so we are reiterating our "3-Retain" rank on their Traditional Value product. We view negatively that they have re-opened their small cap product; however, they are being selective about accepting new mandates so we are also maintaining our "3-Retain" rank on their Canadian Small Cap Equity product. Finally, we received an introduction to their Canadian Dividend Fund which is being managed by Mark and Steve; the product is attractive enough for us to initiate a "B-Moderate Interest" rank.

Organizational Update: Bill Ashby, President, has officially announced that he will retire in June 2010 but they have not appointed a successor. In September 2008, Peter Clarke joined as a Senior Vice President and Partner; he is a member of the servicing and marketing team for institutional clients.

Traditional Value Update: We continue to have concerns that the Canadian team also has global responsibilities; in fact, KC Parker is now officially listed on the Global Equity product. Nevertheless, we continue to have confidence in Mark Thomson's investment abilities and our conviction in this product rests with him. The portfolio was already overweight Financials due to their positioning in the insurance companies; however, Mark added to their bank weights as their valuations had fallen only due to sympathy with the U.S. banks as opposed to Canadian banks actually having significant sub-prime exposure. Furthermore, Mark remains positive that Canadian banks will continue to deliver at least flat earnings and will maintain their dividends. He was also positive on the Telecomm sector as these companies continue to deliver significant free cash flow; he also added to these weights on price weakness.

Small Cap Update: The small cap product is mostly invested in the resources sectors so sensibly, the two key members cover the Energy (Steve) and Materials (Bill, whom we met last year) sectors; however, we are monitoring how the team manages as this resource cycle rolls over. Small cap stocks have lagged large caps so they are finding many attractively priced names. They have been generally most constructive on natural gas (rather than oil) stocks and on gold (but not base metal) stocks.

Dividend Fund: This was our introductory meeting to this product which is co-managed by Steve and Mark. It is similar to the Traditional Value product but with the additional requirement that every stock must have at least a 1.5% dividend yield; as well, it has broader portfolio construction guidelines and allows up to 25% foreign content. We have reservations about cash drag effects and their ability selecting foreign stocks.

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Performance

All performance figures reference June 30, 2008 as the end date.

Beutel Goodman's Traditional Value Canadian Equity Product returned -0.3% for the past twelve-month period; although this was roughly 700 basis points behind the S&P/TSX Composite Index, Beutel Goodman was about 140 basis points ahead of the median value manager. Their returns over the four- and five-year annualized periods were about 450 and 320 basis points behind the index, respectively; as well, relative to the median value manager, Beutel Goodman's returns were behind by about 230 and 150 basis points over these same periods. Their unofficial Q3 return of -9.8% was well ahead of the index return of -18.2%; however, most value managers had extremely strong benchmark-relative performance.

Sector allocation effects accounted for almost all of the underperformance over the past year; the portfolio was hurt the most by being 8% underweight the Materials and also the Energy sectors; as well, they were overweight Financials and both Consumer sectors, which was also detrimental. Their positioning is typical within the Value universe. As expected, the top detractors to performance were their voids in growth names such as Potash, RIM, Canadian Natural Resources and Goldcorp. However, overall stock selection was positive, albeit minor compared to allocation effects.

Beutel Goodman's Canadian Small Cap Equity Product returned 1.6% for the past twelve-month period; this was roughly 1300 basis points ahead of the BMO Nesbitt Burns Small Cap Weighted Index and also about 740 basis points ahead of the median small cap manager. This 1-year return was the only value added return in the past five years but was strong enough to lift their longer-term performance; their returns over the four- and five-year annualized periods were about 40 and 10 basis points ahead of the index, respectively. However, relative to the median small cap manager, Beutel Goodman's returns were behind by about 250 and 210 basis points over these same periods.

In contrast to the Traditional Product, their small cap product had solid selection effects and in fact, their Energy names accounted for almost all the value added over the past year. They were underweight both Energy and Materials which resulted in detrimental sector allocation effects; however, this was not significant.

If you have any questions regarding this manager or these products, please contact Phil Chen at 416-640-2494 or pchen@russell.com.

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