# Our approach to stock selection

Wealth Management

The Global Portfolio Advisory Group is responsible for providing insight to financial and investment advisors in RBC Wealth Management with respect to portfolio construction, asset and sector allocation, and security selection. The group's high-level framework for stock selection tends to be characterized by finding quality businesses, leveraging its extensive research capabilities and forming an independent view, assessing valuation to identify opportunities and risks, and focusing on a longer-term time horizon.

## Quality businesses

Our stock selection approach focuses on identifying good quality businesses. "Quality" is arguably subjective. We define "good quality" as companies having many of the attributes below.

### Sound business models with good visibility

We prefer to invest in companies whose costs, volumes and pricing are relatively straightforward to understand and are improving. We value predictability based on track record and put special emphasis on traits such as strong pricing power and rising backlogs, which are indicative of future revenue generation potential. We look for manageable competitive risks both from within and outside the industry, and prefer companies with flexibility in their cost structures that can help them respond to changing market dynamics.

### High return on invested capital

We believe companies that have been successful at delivering industry-leading returns on capital are often the same companies whose stocks have outperformed for shareholders over the long term.

### Skilled management team

We want to have confidence in the team running the company and making decisions on behalf of minority shareholders. We look for a stable, deep management team with a demonstrated track record of delivering on growth expectations, efficiency in allocating capital, and successful execution of projects and initiatives.

### Reasonable financial leverage

We prefer companies that have strong balance sheets to ensure debt levels are sufficiently covered by earnings and assets.

### Robust cash flow generation

The ability of a business to generate consistent cash flow is an important attribute, in our view, particularly once major capital expenditures are taken into account. Consistent and rising free cash flow (after expenditures) can often leave companies well-positioned to pursue initiatives that can benefit shareholders, including share repurchases, higher dividend payouts, organic growth opportunities, and acquisitions.

We also look to identify catalysts or potential for change. For instance, a change in leadership, an asset sale or spin-off, an emerging cost or competitive advantage, or a diminishing need for capital expenditures are among some of the developments that could improve the outlook for shareholder returns.

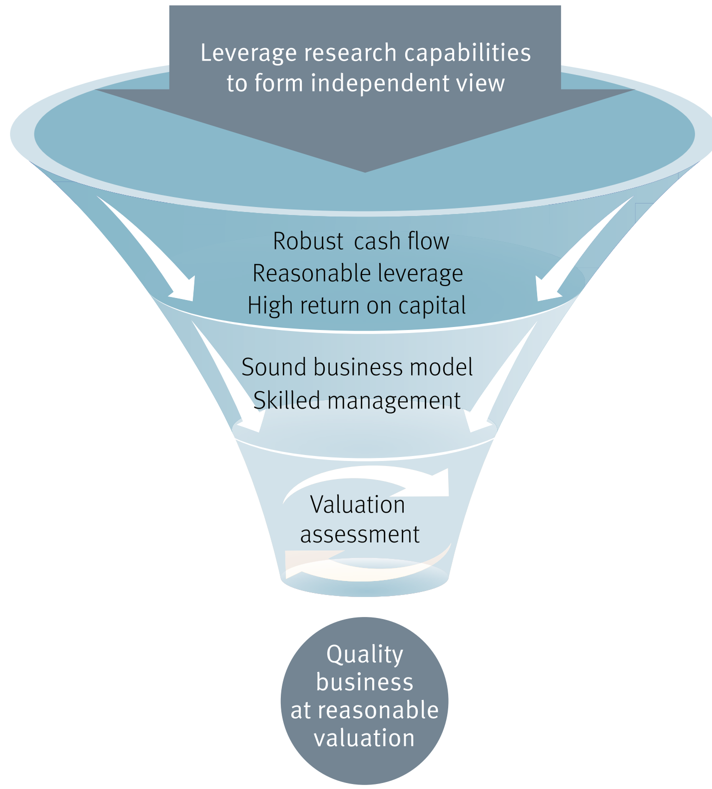
## Research capabilities and forming independent view

The Portfolio Advisory Group has access to extensive research capabilities both internally and through our relationships with external parties.

- **Internal fundamental research —** RBC Capital Markets is our key research partner with approximately 240 equity research staff covering close to 1,600 individual companies across all major sectors of the global economy. We have a long and established partnership with RBC Capital Markets, which gives our group complete access to its team of fundamental industry and macroeconomic analysts.

- **External fundamental research —** We partner with external parties that provide additional fundamental research services that serve as a valuable supplement to our internal capabilities.
- **Transparency and independence —** We strive for transparency and to create and maintain an independent view of stocks based on a combination of our own analysis as well as all the research capabilities that we can bring to bear. We are assessing the return potential of a stock while also considering the risk characteristics and whether a stock is appropriate for investors holding a relatively concentrated equity portfolio.

**Stock selection process**




## Valuation assessment

"A company" and "a stock" are terms that often get used interchangeably. However, there are important differences. The former is an entity that produces a good or service, while the latter is an investment vehicle that reflects the value that investors assign to that business. It is important to assess this value to determine if it is indeed a fair reflection of the underlying business.

We consider a stock's current valuation relative to the future projected earnings and cash flow of the business, its growth prospects, and relative to the stock's history as well as its peers. The analysis and comparisons can help us determine whether a stock represents reasonably good or fair value, and thereby, a potentially attractive investment opportunity.

Perhaps more importantly, it can help determine whether a stock is expensive and reflective of high investor expectations. Expensive stocks can lead to higher risk over time should the underlying business not meet investor expectations, regardless of the quality of the company. We focus on investing in stocks where current valuation affords a margin of safety should results not meet our expectations.

We have access to useful tools that can help us in our evaluation, including: scenario analysis reflecting upside and downside risks, sum-of-the-parts appraisals that more closely review the different segments of a business, and discounted future cash flow projections.

As market prices fluctuate, an assessment of valuation and risk is a recurring exercise that forms an integral part of our stock selection process.

## Long-term focus

Our approach is predominantly focused on the potential risk and reward over a time horizon often measured in years (more than two years on average), as opposed to months or quarters.

We prefer to identify shares of good quality businesses at reasonable valuations for the purpose of investment, rather than trading, as we believe shareholder value is more often accumulated over time than created in a hurry. Given this longer-term bias, we are willing to tolerate a stock's underperformance and volatility over a short-term period if our prevailing view is that the opportunity remains compelling, valuation is attractive, and the risks are appropriate over our long-term horizon.

## Portfolio considerations

The framework above is used to identify individual stocks. But there are a few other noteworthy considerations that are made from a portfolio perspective:

- **Investment Committee —** The construction, support, and communication of the Focus Lists/ Guided Portfolios are driven by an U.S. Investment Committee that is typically comprised of at least two individuals or more from the Portfolio Advisory Group. This ensures continuity of the investment process regardless of personnel changes.

- **Concentration —** Our Focus Lists/Guided Portfolios are concentrated in nature holding between 20–40 stocks depending on the mandate, with the average holding approximately 25 positions. This is much more concentrated than the exposure found in mutual funds, exchange-traded funds, or stock market indexes that typically hold a much broader list of constituents.
- **Sector exposure —** Our Focus Lists/Guided Portfolios are each constructed with some consideration for overall sector exposure to ensure the resulting Portfolio is reasonably diverse with representation across a range of sectors. The degree of exposure can vary and is largely a function of the Portfolio's specific mandate. Furthermore, there may be occasions in which a sector is not represented in a Portfolio if no stocks can be identified based on the investment criteria outlined previously.
- **Low turnover —** The long-term focus of our stock selection approach can result in a relatively lower turnover within our Portfolios, particularly among our core equity selections.
- **Core and satellite positions —** On average, at least 70% of the constituents on each Focus List/Guided Portfolio are deemed to be core stock positions that meet the investment criteria outlined above. In some Portfolios, there may be stocks that are regarded as satellite positions the U.S. Investment Committee believes hold some potential catalyst for change.

*For further details on the investment methodology, please refer to the "Quarterly Report" publications that are available for each Guided Portfolio.*