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STRATEGIES FOR SUCCESSFUL INVESTING

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# A HEALTHY PORTFOLIO

*David Graham, CFA*

IN A LOT OF WAYS, BEING A MONEY manager is like being a doctor. When I go to a dinner party, everybody wants to tell me about their aches and pains.

But instead of showing me where their back hurts, they tell me about their portfolios and especially about the pain in their pocketbooks over the past couple of years.

Lately the majority of the questions I am asked by my dinner companions come down to what they can hold in their portfolios that will offer a good yield.

While yield seems to be a simple term, without a qualifier it can be confusing to investors. Generally what they mean by yield is the income return they can get on an investment.

It is obvious that most people I meet across the dining room table are not satisfied with the income they are getting from their money market investments and other safe assets.

But as soon as I start to make a few general suggestions, it's not too long before I hear, "I don't want to lose any money," or "Is there any risk?"

I understand their concerns, but the truth is they can't expect higher returns without taking some risk.

As investors, we all have choices. If we leave our money sitting in a savings account at the bank, only a very small amount of interest will accumulate. But you can be relatively certain you won't lose any money. However, you can be absolutely certain that your money isn't going to multiply by large magnitudes, especially after taxes.

There are alternatives, of course, all of which have increasingly higher degrees of risk.

Investors can buy a company's debentures – bonds that are backed only by the general creditworthiness and reputation of the issuer – and receive a higher rate of interest.

They can buy preferred shares, which have a dividend that must be paid out before dividends are paid to common stockholders.

As long as the company has a high credit rating, there is usually less risk of not receiving steady income as well as the return of the money you originally invested.

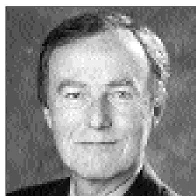
But debentures and preferred shares still fluctuate along with interest rates.

Generally, as interest rates go up, the income or dividend stream isn't worth quite as much as it used to be in real terms, thanks to inflation. Anyone buying the investment from you might want to pay less.

Buying common shares that pay dividends is another way to get a higher yield for your money.

When companies start up, they usually use all of their cash flow to grow their business. But as they mature, most successful companies tend to generate more cash than they require for business maintenance and other needs. They may then distribute a portion of their earnings in the form of a dividend.

Therefore, the total return on investment in common shares of an established company can be a



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combination of both capital gains and dividends.

With common stocks there is always stock market risk, which goes up and down depending on the economy and other factors. Additionally, there are company-specific risks.

Together these risks are usually greater than the interest rate risk you face with preferred shares or debentures.

This all seems very simple when you are trying to explain it over a Caesar salad, but balancing risk and reward is a challenge, even if it is my day job.

The **CIBC Monthly Income Fund** and the **Renaissance Monthly Income Fund** are balanced funds with a focus on generating income.

So, my team and I are always trying to fine-tune the risk and reward among the asset classes I have mentioned. This way, over a period of three to five years we can provide a more balanced risk-adjusted return than the stock market.

In our monthly income portfolios we hold bonds, preferred shares, several stocks that have attractive dividend yields from which we can expect some capital appreciation. As well as some stocks where capital appreciation is the main goal.

## SOLID YIELD

Rather than choosing companies that simply offer high yields, we focus on the ones we think can maintain or even increase those dividends over the foreseeable future. Here are a few of the choices we have made.

***Income trusts:*** Income trusts offer high yields but many are converting to a corporate structure. Here's a former income trust we like that has made the conversion successfully.

**Crescent Point Energy** (TSX-CPG, $38.22) is an oil and gas producer focused on oil production in Alberta and Saskatchewan.

When Crescent Point Energy converted to a corporation from a royalty trust back in 2008 it maintained its distribution as a dividend, and currently yields seven per cent.

Not only is Crescent Point Energy attractive for its yield but we also like it because management typically hedges about 50 per cent of the current years production and 30 per cent of next year's production. This allows for a more predictable revenue stream over time.

We expect Crescent Point Energy's stock price to fluctuate with oil prices, but to a lesser degree than other producers.

Although the company's dividend is dependent on oil prices, we believe prices would have to fall significantly before the current dividend would be jeopardized.

An income trust we like is **Cineplex Galaxy Income Fund** (TSX-CGX.UN, $17.67). The trust owns 129 cinemas and over 60 per cent market share in Canada.

It may be hard for another movie to duplicate the box-office success of *Avatar*, and the line-up of 3D movies, but 2010 and 2011 should keep revenues strong for exhibitors.

Cineplex Galaxy is always finding new ways to capture a bigger share of your wallet with concession booth sales, its Scene loyalty card, opera and sports broadcasts, website sales, and even its showcase of live Vancouver Olympic coverage.

Cineplex Galaxy currently yields 6.9 per cent as an income trust, and we expect it will able to maintain this distribution when it converts to a corporation.

***Telecom stocks:*** Other stocks that offer above average yields tend to be in the more stable, defensive sectors like the financial and telecommunications sectors.

**BCE Inc.** (TSX-BCE, $27.47) is one telecom that currently offers an attractive 6.3 per cent yield.

The company has gone through dramatic cost cutting over the past two years as it prepared to be taken private. When the proposed takeover fell through, not only was BCE financially sound, but its management remained focused on being lean and mean.

The outlook for earnings growth for the major Canadian telecommunication companies is modest because there is very stiff competition in wireless communication right now. Specifically, the government is encouraging more new competitors like Wind Mobile.

Telecommunication companies have been out of favour due to increased competition as well as concerns about the impact of the recession.

BCE's earnings growth is down as its core customers are slowly but steadily exchanging their landlines for cell phones. However, the company recently raised its annual dividend from $1.60 to $1.74. We view this as a sign of confidence.

Another telecom we like is **Rogers Communications** (TSX-RCI.B, 33.36). It is perceived to be even more vulnerable than BCE to wireless competition. That's because of its 40 per cent market share stake in cell phones.

Rogers was the first to introduce the Apple iPhone to Canada. While this would generally be considered a positive, it was initially a drag on earnings because telecommunications companies

typically sell the phones below cost expecting to make their money back in future revenues from usage fees and services.

Although Rogers went through a period of vigorous cell phone activations with weaker initial financial returns, we believe this trend will turn positive.

Rogers currently yields 3.6 per cent, but the company should be able raise its dividend as its clients discover the minute-eating applications they can't live without.

***Financial stocks:*** Let's not forget about Canada's major banks for their yield, currently between 3.7 per cent and 5.3 per cent.

One of our favourites, **Toronto-Dominion Bank** (TSX-TD, $63.49) currently yields 3.8 per cent and is trying to be one of North America's largest banks by expanding into the U.S.

Canadian banks have weathered the recession better than their global competitors and TD management wants to grow now while its U.S. competitors are still weak.

The U.S. presents risks in the form of competition, loan losses, and taxes generated by the Obama administration. However, there are also opportunities created through market share and loan growth.

TD's profitability is currently higher in Canada than the U.S., but we believe it is only a matter of time before this changes if it sticks to its proven Canadian formula.

All global banks will face more regulation and tough capital rules, but we believe the Canadian banks already meet many of the recent regulatory recommendations because of Canada's stringent banking rules.

All of these companies offer yield but they also have some degree of risk. In our opinion the presence of yield mitigates some of that risk.

In a large diversified portfolio like the CIBC Monthly Income Fund or the Renaissance Monthly Income Fund their risk characteristics are even further diminished.

So you'll want to diversify your picks as well as cut down on risk. Now there's some food for thought at your next dinner party. ▼

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