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STRATEGIES FOR SUCCESSFUL INVESTING

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GROW WITH DIVIDENDS

Domenic Monteferrante, CFA

Dividend-paying stocks are the ideal investment choice right now and will be for some time. This is the clear conclusion of a recent CIBC World Markets report.

Historically, North American dividend stocks do best when the threat of inflation is minimal and economic growth is less than two per cent, which is the case right now.

Since 1990, Canadian dividend stocks have beaten the overall S&P/TSX Composite Index by about five percentage points when growth is below two per cent.

Domenic Monteferrante CFA is First Vice President of Canadian equities at CIBC Global Asset Management Inc. and is responsible for the dividend mandates, including CIBC Dividend Growth Fund, the CIBC Dividend Income Fund and the Renaissance Canadian Dividend Fund.

Because investors are drawn to dividend stocks in slow economic times, it propels these stocks up.

In a low interest rate environment, which is also the case now, dividends can outpace the returns from bonds. The dividend yield on the S&P/TSX Composite Index currently is about 70 basis points (0.70%) higher than the yield on the Government of Canada's 5-year bond.

A stock dividend used to be considered the icing on the cake. In this economic mix, dividends have increasingly become the cake itself.

With two market collapses in less than a decade, and volatile equity markets even now, there is less confidence in the ability of stocks to deliver adequate returns on price appreciation alone.

The trend toward dividend investing is expected to continue as the population ages. Because of the assurance of a reliable income stream, dividends look attractive for baby boomers on the verge of retiring.

High-yield bonds may offer better returns, but many seniors don't want to reach that far down the quality ladder.

Dividend payouts will also likely rise as companies look for ways to reward investors for sticking with them through the downturn.

The sectors with the highest possibility of dividend hikes are the utility, financial and telecommunication sectors, but energy, industrials and health care also have pockets of companies with better than five per cent yields.

The number of firms cutting dividends has also sharply declined. Only about three per cent of Toronto stock exchange dividend announcements in the third quarter of 2010 contained rate reductions, a fifth of the level at the recession's peak.

While history shows that a low interest rate environment is the right climate for dividend-paying stocks to outperform, we at CIBC Global Asset Management Inc. would argue that dividend-paying stocks should never be viewed as just the flavour of the day.

Dividends should be an inte-

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gral consideration for any long term investment portfolio irrespective of where we are in the market cycle.

We believe it is wise for investors to seek dividend yielding securities as part of their overall investment mix and we believe that the Canadian market provides a number of good candidates with dividend growth characteristics.

A high ratio of dividend-paying stocks tends to offer better downside protection to a portfolio.

Academic studies have shown that dividends are an important component of total equity returns – U.S. data shows that since the 1930s, a dividend-focused investment strategy has outperformed the overall market in every decade except that of the tech-bubble driven 1990s.

At the most basic level, promising to pay a consistently growing dividend obliges a company to maintain financial discipline in order to live up to its dividend paying requirement.

A dividend tends to enhance the value of the stock versus a non-dividend paying stock. An investor can better assess future cash flow streams for the investment.

A growing dividend indicates that the company has sufficient capital to fund internal growth with its cash flow.

However, a high-yielding dividend stock alone does not necessarily portend capital appreciation or above-average total returns.

Sometimes a high-yielding stock sends out a signal that the market expects that the dividend distribution is not sustainable over the long term, and has driven the stock price lower as a result.

Sound fundamental research is also needed to validate an investment in a dividend-paying stock and the sustainability of the dividend.

My mandate is as portfolio manager for the CIBC Dividend Growth Fund, the CIBC Dividend Income Fund and the Renaissance Canadian Dividend Fund.

Our team manages all our portfolios with the same core investment principles – a yield higher than the index, a well-diversified large cap portfolio, and exposure to all major sectors of the equity market. We maintain a value tilt bias.

That is, the valuation metrics of the total fund – the price to earnings and the price to book ratio – are more conservative than that of the market.

Our screening tools help us select stocks with dividend growth characteristics and to generate a universe of candidates.

We begin by seeking those companies with a minimum yield of one per cent.

Then we look at the recent history of the company and note whether the dividend has grown over the last two years.

A growing dividend indicates that the company has sufficient capital to fund internal growth with its cash flow.

We examine whether the one year forecast for growth in earnings or the free cash flow of the company is 10 per cent or greater, and whether the payout ratio is no higher than 60 per cent (a payout ratio is the percent of earnings that is distributed in dividends).

These metrics help us determine whether or not the company has the financial capacity to increase its dividends in the future.

For example, if earnings are growing at three per cent and the company's payout ratio is at 95 per cent, it would seem to be something of a challenge for the company to increase its dividends at a sustainable rate.

That is how we came to include **Enbridge Inc.** (TSX-ENB, $56.20) in our portfolios. We forecast an average annual earnings growth rate of 10 per cent for Enbridge over the next five years, and the company would, in our estimation, be in a position to increase its dividend at a rate higher than that over the same period.

Enbridge, formed in 1949 as Inter Provincial Pipeline, is one of North America's major energy pipeline companies and has been expanding its network through organic and external growth for decades.

In more recent years it has benefitted from the growth of oil sands production in Western Canada.

Saputo Inc. (TSX-SAP, $36.87), a dairy food products manufacturer, is another interesting dividend growth stock.

Saputo has a dominant market share in Canada and it also ranks among the top three cheese producers in the U.S.

Our estimate of organic earnings growth is in the mid to high single digits and, unless it makes a major acquisition, it should be debt free by 2012.

Tim Hortons (TSX-TIH, $39.10) has an internal policy of distributing 30 per cent to 35 per cent of its prior year's normalized

income, and can conceivably increase its dividend at a low double-digit average annual rate over the next five years.

Tim Hortons is the fourth largest publically traded restaurant chain based on market capitalization in North America.

About four out of every ten visits to a Canadian quick service restaurant are to a Tim Hortons where it has almost a 75 per cent market share of baked goods and a two-thirds share of the coffee market.

Given its business franchise and royalty structure we believe the company can generate high cash flows.

Canadian banks have been traditional candidates for dividend increases because of the breadth of their businesses across the financial landscape and because of their capital structure.

The last few years have been challenging for the financial industry.

Yet with an outlook of high single digit earnings growth and armed with greater clarity from the Basel III proposals on the future of capital requirements for financial companies, we think **National Bank** (TSX-NA, $66.72) and **Toronto-Dominion Bank** (TSX-TD, $73.90), for example, could be in a position to augment dividends sometime in 2011.

The sluggish economic recovery that CIBC Global Asset Management believes is in store for the next year or more is an environment positive for dividend stocks.

This adds impetus for investors to continue "clipping the coupon" in the equity market, and not just the bond market. But it is our view that dividend stocks provide a useful portfolio anchor not just now, but in any environment. ▼

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