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STRATEGIES FOR SUCCESSFUL INVESTING

VALUE INVESTOR

Investors' love affair with dividends can be costly. Instead, combine consistent cash flows with long-term growth for...

TOTAL RETURNS

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Investors have fallen in love with dividends. And rightly so, since dividends have historically accounted for a substantial amount of total return. But like the old Waylon Jennings song, investors may be "looking for love in all the wrong places."

And while we continue to believe that stocks of high-quality businesses with above-average yields will perform well, we caution investors that some traditional areas of dividend yield have become expensive. As value investors we are always in the pursuit of yield, but not at any price!

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It is important not to overpay for the underlying business.

The **CIBC Canadian Equity Value Fund** and the **Renaissance Canadian Core Value Fund** search the market for the best investment opportunities with the highest total return potential.

For us, total return includes both share price appreciation and the accumulated dividends. More than ever, we believe that a portfolio anchored with value investing and quality dividends will outperform the market in today's volatile environment.

Dividends have earned a reputation as key drivers of equity returns. Dividend-paying stocks have a history of outperforming non-dividend paying companies and the market.

Also, investing in businesses that regularly raise their dividends over time expand their leadership. From December 1986 to June 2012, companies that increased their dividends generated a compound annual return of 11.9, while companies that did not returned 10.0 per cent.

However, both outperformed the S&P/TSX Composite Index return of 6.2 per cent. In contrast, companies with no dividends delivered a compounded return of a meagre 0.3 per cent.

The Canadian banks are a powerful example of the benefits of dividends. Over the last 20 years, banks have expanded their earnings at a compound annual growth rate (CAGR) of 9.1 per cent, well in excess of the 4.1 per cent growth experienced by the average company in the S&P/TSX Composite Index.

The strong compounding of earnings and cash flows consistently generated excess capital that banks were able to return to shareholders in the form of share buybacks and dividends. Over the last 20 years, dividends at the banks have grown at a CAGR of 9.9 per cent, compared to 5.3 per cent for the S&P/TSX Composite Index constituents.

During that time, the bank subindex generated a compound annual total return of 10.4 per cent compared to the S&P/TSX Composite Index's return of 6.4 per cent.

CIBC Asset Management finan-

cial analyst Owen Ko believes that the bank's long-term dividend growth story remains intact.

Over the long term, the unique nature of the Canadian banking industry – coupled with strong cost management, high capital positions, and solid internal capital generation – bodes well for equity investors.

We expect the banks to continue maintaining their legacy as strong dividend growers. Our value funds continue to overweight the sector with favoured positions in **Royal Bank** (TSX-RY, $56.85), **TD Bank** (TSX-TD, $81.80), **CIBC** (TSX-CM, $76.95), and **Bank of Montreal** (TSX-BMO, $58.40).

We believe that it is important to consider the potential total return of an investment. We continue to push for an above-average yield in our value funds, while ensuring we buy good businesses that are trading below their historical long-term average valuation.

Our internal research team works diligently to identify the best risk/reward opportunities. Their work identifies situations where investors are over-paying for yield and may potentially be exposing themselves to capital losses.

As investors began looking for alternatives to fixed income in this low interest rate environment, traditional areas of dividend yield experienced significant demand. Consequently, sectors such as Utilities and REITs enjoyed strong interest from investors.

From December 2005 to June 30, 2012, the REIT and Utilities sub-indices generated a compound annual total return of 9.9 per cent and 5.7 per cent, respectively. In comparison, the S&P/TSX Composite Index generated a total return of 3.2 per cent over the same period. As a result of the strong price performance, the valuation of these traditional yield investments has expanded dramatically above historical norms.

The recent outperformance of these traditional sectors has pushed their valuations higher. Utilities now trade 15 per cent higher than their long-term average, while REITs are currently trading at an approximately 22 per cent premium to historical averages. Investors have been rewarded for owning these sectors.

What's absent is a corresponding increase in the earnings of these businesses; their stock valuations have expanded beyond typical levels. Financial markets, on the other hand, have a tendency to revert to the mean in the long-term. Above-average valuations are never sustained indefinitely.

As a source of yield, the contrast between the banks and the REITs is striking. The yield on the REIT sector is actually below that of the banks. While REITs trade at a valuation premium to their historical average, banks are currently trading at a discount to normal levels.

Over time, the compounding and reinvesting of dividends contributes to wealth creation. CIBC Global Asset Management's value funds continue to demonstrate a focus on dividends through our fund's holdings. As of August 30, 2012, 39 of the Renaissance Canadian Core Value Fund's 40 Canadian holdings paid a dividend.

The combination of consistent cash flows from dividends and disciplined value investing – buying attractive businesses when they are temporarily unloved – will contribute to strong investment results over time.

We encourage investors to continue to seek yield in the low-interest-rate environment, but not at any cost. A total return approach, including returns from both dividends and capital appreciation, will help investors to avoid an expensive love affair. ▼

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