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STRATEGIES FOR SUCCESSFUL INVESTING

INCOME INVESTOR

Choosing the right mix of bonds and dividend-paying stocks will give your portfolio some...

DOWNSIDE PROTECTION

David Graham, CFA

WE BELIEVE STOCKS OFFER FAR better value than bonds today, but they also have far higher volatility.

With the continuing uncertainty in the financial world, the stock market can easily be up or down one or two per cent in a day.

Choosing the right mix of stocks and bonds can be one of the most confusing decisions facing any investor. How much you allocate in each asset class should depend on your time horizon and your risk tolerance. For example, the CIBC Monthly Income Fund is geared towards preservation of capital, and therefore is fairly evenly balanced.

Let's take a look at the current economic backdrop and the case for stocks versus bonds today.

The global recovery appears to be more solid now than it was a year ago.

The key positive, in our view, is that central banks are in an easing mode compared with last year, when both the European Central Bank and the Chinese authorities were tightening. Although growth in Canada and the United States continues to be sub-par, it's still a steady two per cent or so.

Canada has had surprisingly good job growth, and the slightly lower Canadian dollar should also help our economy.

China's economy, meanwhile, appears to be slowing. But the authorities there have already started to ease, and there is talk of doing more. Economists still expect about eight per cent growth this year and next.

Europe is the big question mark. The continuing austerity forced on member countries by Germany will likely mean no growth or a small recession in Europe this year.

There is the risk that Greece will leave the euro currency union in the months ahead, and no one really knows the implications of that – on Greece, European banks or other economies, including North America.

Finally, at the end of this year the U.S. will face its so-called "fiscal cliff," a precipice consisting of various tax cuts from past years (and that are due to expire in 2012) combined with austerity measures set to kick in at the beginning of 2013.

For example, the top tax rate on dividends and capital gains is scheduled to increase at the year-end. Any or all of these measures could be extended by politicians – but if not, the impact could offset all of the growth in the economy in 2013.

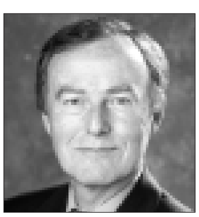
The Congressional Budget Office says these changes could possibly put the U.S. back into recession.

In addition, the U.S. debt ceiling will have to be raised either in the fourth quarter of 2012, or early in 2013. Will we go through the 2011 debacle all over again?

We believe the global recovery should continue, but it will remain sluggish for some time.

The main offset to a recovery is on-going debt-reduction measures being undertaken by consumers, governments and European banks.

In the 1990s, the average debt/GDP ratio of all 34 OECD countries was around 73 per cent.



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Even in 2007 – just five years ago – it was still 73 per cent. By the end of 2012 it will be 106 per cent.

REWARDS AND RISKS

We can think of several reasons to own stocks today.

✓ ***Valuations:*** The S&P/TSX Composite Index & the S&P 500 Index are selling at about 12.3 times and 11.9 times forward earnings estimates today. This compares to 30-year averages in the 14.5 to 15.0 times range.

✓ ***Dividend yield:*** Today stock yields are far higher than bond yields. The S&P/TSX Composite Index dividend yield is currently 3.0 per cent, compared to a 10-year Government of Canada bond yield of 1.85 per cent.

Over 130 stocks in the S&P/TSX Composite Index today have dividend yields over 1.85 per cent. This is only the second time since 1958 that the Index yield has exceeded the 10-year bond yields.

✓ ***Corporate balance sheets are strong:*** Companies have been reducing debt and/or refinancing debt at lower interest rates. Many companies now have healthy amounts of cash on their balance sheets.

We expect continued dividend growth given the health of balance sheets and operating margins. Many management teams have signaled a plan to grow dividends alongside earnings. This is unlike bonds, where you get a flat interest payment until maturity, the yield on your initial investment should grow over time.

✓ ***Negatives already priced in:*** The stock market is already down nine per cent from its February 2012 high, and 18 per cent from the March 2011 high. The outlook can always worsen, but a lot of the negatives have to be priced in at today's levels.

The main case against stocks is the number of serious uncertainties facing the market which, while too difficult to quantify, lead to lower valuations.

No one really knows whether the problems in Greece will spread to Spain and other countries, or if Greece will exit the euro; if the U.S. will extend the tax benefits due to expire; or if China's economy will slow more before it recovers.

Bonds, on the other hand, are not as attractive today (a 1.3 per cent 5-year yield or 1.8 per cent 10-year yield doesn't even offset inflation), but they offer much more capital preservation than equities.

A realistic concern today is that earnings expectations are still being revised lower as analysts lose confidence in the outlook.

At December 30, 2011, consensus estimates for the S&P/TSX Composite Index earnings in 2012 and 2013 were $992 and $1,129, respectively. By April 30, 2012, they had dropped about eight per cent for each year.

The largest revisions have been in the technology sector, while estimates for the materials and energy sectors have also been substantially reduced. One of the sectors least impacted by revisions has been the financials.

Many of the stocks in the commodity sectors have fallen as much or more than the earnings estimates, but those estimates are probably still the most at risk.

The question is whether commodity prices have further downside if we hear more negative economic news, or if all the pessimism has already been factored in.

We will be much more comfortable when we start seeing revisions in earnings estimates going upwards, rather than down.

The argument we often hear about bonds is that when interest rates rise, investors will lose money. While it's true that bond prices go down when interest rates rise (if rates rose one or two per cent, the return on a 10-year bond – price change plus interest – might suffer a loss of five to 11 per cent), what economic scenario would justify a two per cent increase in interest rates?

We don't see one in at least the next two years, not with the austerity and debt reduction needed.

OUR FUND – AN OVERVIEW

In the CIBC Monthly Income Fund today, we are erring on the side of caution. We favour equities over bonds, but see uncertainties that could take the market even lower.

We also have less faith in politicians to initiate any major spending programs. They will likely extend some benefits or tax cuts, but only the minimum necessary. No one wants government debt to grow any faster.

Looking at the big picture, our income fund reduced its equity weight dramatically over 2012 and our current position is a lot more conservative than a year ago.

We have also increased the bond weight in our portfolio. Corporate bonds represent a higher proportion of the portfolio than government bonds.

Last year the move in interest rates surprised me – the 10-year rate dropped from over 3.4 per cent to about 2.0 per cent, resulting in a 10 per cent return in the bond market.

Our Fixed Income team thinks the Canada 10-year bond yield should trade in a range of 1.8-2.25 per cent, and we are below that range today – perhaps a reflection of the continuing negativity. Things would have to be very bad for interest rates to dramatically drop from this point. So rather than buying bonds today, we have a large cash position.

As we reduced our equity

weight, all of the selling was in resources and in the more volatile or high beta names e.g., **Barrick**, **Goldcorp**, **Teck Resources**, **ARC Energy**, **Penn West Petroleum** and **Magna**.

We learned last year that, even though the dividends may be totally safe, investors will worry anyway and the stocks will go down.

We kept our overweights in financials and telecoms, these are sectors where there are good yields and only minor earnings revisions. Our focus since last fall has been on stocks with good yields and growth in dividends.

We favour equities over bonds, but see uncertainties that could take the market even lower

Studies have shown that stocks with good yields have about half the volatility of stocks that pay no dividends. There is an assortment of names in the portfolio, including the banks, BCE or Telus, AltaGas and Enbridge – all of which have good yields today, and are expected to generate strong dividend growth going forward.

We have also added a few new names in the last month:

☛ **Sun Life Financial Inc.** (TSX-SL, $20.51) Like Manulife, the company is restructuring to focus on more profitable businesses. Our team believes it is far less sensitive than Manulife to changes in rates or the stock market, and its dividend is safe. This stock has an approximate dividend yield of seven per cent.

☛ **TransAlta Corporation** (TSX-TA, $16.76) has coal and gas power facilities in Alberta and the U.S. It supplies 30 per cent of the power in Alberta. Two items have hurt the stock price. First, TransAlta closed two coal facilities last year, reporting they were uneconomic and too costly to repair.

There is an arbitration board hearing that will decide whether purchasers of the power from those facilities should receive any compensation. That decision comes in July. Depending on the outcome, some believe the company may have to access the capital markets to raise funding. Our team believes the company has the balance sheet strength to cover any potential penalties.

Secondly, TransAlta has electricity contracts coming up for renewal at their U.S. gas plants this summer. With natural gas at $2, some analysts have said the company will have to drop the price of electricity to their customers to remain competitive. These electricity contracts are for 5-10 years, so we expect the prices to perhaps be lower in the medium term, but return to some kind of normalcy over time.

Regardless of the outcome of the two events, our team feels the dividend of just below seven per cent will be maintained.

TransAlta also has a dividend reinvestment program where most shareholders reinvest the dividends, and therefore the cash payout is very low. We purchased the stock because we felt its value has been impacted by an overreaction to the negative headlines and event risk.

☛ **Cominar Real Estate Investment Trust** (TSX-CUF.UN, $23.75) is Canada's third largest REIT. The trust is diversified with 46 per cent of income from office properties, 31 per cent from retail and 22 per cent from industrial.

The recent purchase of CANMARC in March provided more geographic diversification, reducing its Quebec exposure from about 90 per cent to 78 per cent and enabling the REIT to obtain an investment grade credit rating.

Rental income could always be at risk in an economic slowdown, but we believe the 6.1 per cent distribution yield is relatively secure.

REMAIN CAUTIOUS

Stocks appear very inexpensive today. The debt problems in Europe will take a long time to resolve, but if the next Greek election has favourable results, we could get a relief rally over the summer.

Moves by the Federal Reserve, the ECB or the People's Bank of China to provide more stimulus could also be viewed positively and lead to a market rally.

In order to get a bigger and more sustainable rally this fall, we need more clarity on what U.S. politicians plan to do with the debt ceiling and the tax cuts that are due to expire.

Until then, I think a neutral stance is the best position and one where you can collect your dividends. We're trying to be cautious and protect the downside. ▼

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