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STRATEGIES FOR SUCCESSFUL INVESTING

MARKET WISDOM

A strategic mix of dividends and low-risk capital appreciation is a winning combination for the yield-hungry investor

BORING IS BEAUTIFUL

Stephen Carlin, CFA

INCOME-SEEKING INVESTORS HAVE a real dilemma.

A financial crisis hangover, coupled with a sub-par economic recovery, has produced a low-interest-rate environment for an extended period of time.

Consequently, this has created a mixed blessing for income-hungry investors.

On the positive side, fixed income – considered the anchor and income-generating component in most investors' diversified portfolios – has generated excellent investment returns for the last 20+ years.

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On the negative side, stubbornly low interest rates have generated lower investment income and stifled opportunity for future capital appreciation.

The consensus view is that interest rates will rise in the next 12 to 18 months, creating a headwind for investors who have enjoyed the income *and* capital-generating benefits from the fixed income portion of their portfolios.

Against this backdrop, where does the income-seeking investor turn? What if you could have your cake and eat it too?

As both a portfolio manager and an investor who has tracked diverse economic growth phases and stock market cycles, it often surprises me that investing in dividend-paying stocks has not been more de rigueur.

For the record, I love dividends. For the longest time they were considered the "no respect" Rodney Dangerfield of the stock market. They were not seen as a sexy growth story. Instead, dividend stocks were considered boring, slow-growth companies.

But boring is beautiful! In fact, the more boring, the better.

Over longer time horizons, studies have shown that dividend-paying stocks typically perform better than the overall stock market. Dividend-paying stocks may waver in popularity but they stand out because they can provide more downside support in choppy markets.

In order to be successful with this strategy, however, you must pick quality dividend stocks that exhibit financially strong characteristics over a market cycle.

Because dividend-paying stocks provide investors with an annual yield, they tend to exhibit lower volatility compared to the overall stock market.

This characteristic is especially beneficial in times of nervous markets or slower economic growth.

For example, if a stock pays a dividend that yields four per cent and the stock falls by 10 per cent (due to overall market negativity and not company specific events), the yield would then rise by 10 per cent to 4.4 per cent.

This increase anchors the stock, typically making it less likely to plummet versus a stock that pays no dividend.

The financial crisis hurt dividend-paying stocks – but they

were also the first to recover, as they tend to exhibit stronger resiliency in their overall business characteristics relative to their non-dividend-paying brethren.

GET PAID TO WAIT

By focusing on financially strong businesses that can withstand economic slowdowns, a dividend investor gets paid as the business grows over time, even if that growth ebbs and flows during a business cycle.

Slower-growing companies are generally less sensitive to the economic cycle compared to other growth-oriented businesses.

As well, they tend to generate higher and more stable free cash flow, which is the perfect recipe for a dividend-seeking investor.

High-quality, dividend-paying stocks continue to pay investors along the way. The dividend yield generated by the stocks in the Canadian benchmark S&P/TSX Composite Index was 2.8 per cent on May 31, 2014 – a more attractive yield than that earned from investing in a 10-year Government of Canada bond.

As well, since dividends are taxed more favourably than interest income, the after-tax difference is likely even greater.

THE POWER OF COMPOUNDING

For a company to boost its dividend (see box above), profitability should be rising along with the overall value of the business.

But even if the market did not recognize this, given the current low-interest-rate environment, the stock would attract investors strictly because of its high yield.

This theoretical scenario is especially attractive to an income-seeking investor because of the dividend source of return (yield), coupled with strong potential for capital appreciation.

Of course, a company can rarely grow its dividend by 15 per cent a year. A five to 10 per cent annual growth rate is much more realistic.

The table on the following page shows an example of 5-Year Dividend Yield Growth Rates

Compounding – An example

The chart below shows a theoretical company, with a stock valued at $25.00, that could grow its dividend by 15 per cent annually, effectively doubling its dividend in just five years. The third column highlights the dividend yield change if the share price is held constant over that same time frame.

Surely this company's stock price should also rise due to its historical dividend growth. The rationale behind this is that dividend policies are usually based on a company's inherent profitability and cash flow generation.

Year	Dividend Growth @15% per year	Dividend Yield
Current	$1.00	4.0%
1	$1.15	4.6%
2	$1.32	5.3%
3	$1.52	6.1%
4	$1.75	7.0%
5	$2.01	8.0%

This chart shows different dividend yield outcomes based on varied dividend growth rates.

If company ABC begins with a four per cent dividend, and grew its dividend by five per cent a year, the yield on the stock in year five would rise to 5.1 per cent. If the dividend grew by 10 per cent a year, the yield would climb to 6.4 per cent.

Annual Dividend Growth Rate

Year	0%	5%	10%
1	4%	4.2%	4.4%
2	4%	4.4%	4.8%
3	4%	4.6%	5.3%
4	4%	4.9%	5.9%
5	4%	5.1%	6.4%

The key to this strategy is to focus on companies with sustainable, and growing, dividends. Compare that to an investor buying a Government of Canada bond, in which the government will only pay what they promised – and not a nickel more.

A 2.5 per cent yielding bond will only pay you the 2.5 per cent coupon plus the principal payment at maturity. There's no option to boost that payment.

So if interest rates start to rise, this bond investment has no cushion to offset against the negative impact of a rising interest-rate environment (i.e., this type of environment causes the price of a bond to go down, all else being equal).

Yield-seeking investors must be careful NOT to get trapped or tricked into blindly buying stocks with above-average yields. Stocks with really juicy yields may foretell a story of higher risk, not lower risk.

I have seen many examples of underperforming high-dividend-yielding stocks in which company management grows anxious

because the stock price is falling due to the company's weak financial performance.

In desperation, they believe that, "if we can maintain the dividend payment (keeping it as a high-yield stock), we can hold up the stock price."

In this case, hope is not a strategy. In the end, this stock may greatly disappoint the investor.

I caution investors to do the fundamental work on the company's financial strength, or perhaps think about working with an investment professional that can help identify and manage some of the risk.

BANKS, PIPELINES AND REITS

One of the primary determinants of dividend sustainability is a metric called the "dividend payout ratio."

Basically, it's a measure of the percentage of a company's earnings that are paid out as dividends to the shareholders of that business. The higher the payout ratio, the lesser chance there is that a company can raise its dividend unless the business grows enough to justify the increase.

In Canada, we have a number of quality dividend-paying businesses with attractive (boring!) growth opportunities. Canadian banks and the energy pipeline industry are two good examples of steady, high-quality, dividend-paying companies.

Over the last five years, the Canadian banks have increased their dividends, on average, by more than four per cent while also successfully growing their business (measured by profits) by an equal or greater amount.

This has provided a very attractive combination of yield and capital appreciation to investors. The pipeline industry has exhibited a similar trend.

Real estate is another Canadian sector that produces attractive dividend yields for investors. However, the real estate investment trust units (REITs) sector has very high dividend payout ratios and therefore we view this sector as having only modest potential to grow its dividends in the future.

Because there's less chance to increase dividends, REITs more closely resemble a bond compared to a bank or a pipeline stock. To be clear, we still look to REITs to generate dividend yield in our portfolios, but we are not expecting significant increases in the future.

Here are the Dividend Payout Ratios followed by the Dividend Yields for these sectors (as at May 31, 2014):

	Sector	Payout Ratio	Yield
✓	Banks	46%	3.8%
✓	Pipelines	75%	3.2%
✓	Telecoms	77%	4.7%
✓	REITs	83%	5.9%

Note: The above sectors are stable and growing with the exception of REITs, they are stable and maturing.

FAVOURITES

Our favourite name in the Canadian bank sector today is **Bank of Nova Scotia** (TSX-BNS, $70.52).

Scotiabank offers a dividend yield of 3.7 per cent, as compared to the Canadian bank average of 3.8 per cent. It has stable business growth prospects over the next couple of years, exhibits a strong capital base, and is well positioned to increase its annual dividend over the next few years.

In the past, Scotiabank traded at a premium valuation to the bank sector whereas today BNS trades in line with the group, making this an attractive stock.

TransCanada Corp. (TSX-TRP, $50.89) is one of our favourite stocks in the pipeline sector. With an attractive dividend yield of 3.8 per cent and visible growth in its business for the next five years, TransCanada trades at a discount to other comparable companies, and has a track record of increasing its dividends over the last five-year period.

DIVIDEND INVESTING = BASEBALL

Focusing a portfolio on quality dividend-paying companies is like having a runner on second base.

Think of the runner as the yield in your portfolio. In order to score a run for your team, the batter (your portfolio) doesn't have to take "a big swing for the fence" (i.e., take high risks) to produce a run. In fact, hitting a single could get the runner home.

Yield and singles produce performance. Or to put it plainly, a strategic mix of dividends and modest, low-risk capital appreciation is a winning combination for the yield-hungry investor. ▼

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