The case for dividend paying stocks

Dividend stocks have shrugged off every piece of bad news that's hit the market in the last couple of years – the European debt crisis, China's slowdown and the sluggish US economy.

But many investors feel that perhaps the "yield" trade has become crowded. While this may have some truth to it, it is our opinion, that the yield trade is still in favour and the fundamental reasons to own dividend paying securities in your portfolio are still strong.

Why are more and more investors choosing dividend paying securities? Here are a few of the reasons:

- Advantageous Tax Treatment
- Favourable/abnormal risk reward trade-off
- Low interest-rate environment
- New class of buyers
- Overvalued government bonds

Investors in the highest tax brackets in 2011 should generally retain $68-82 of every $100 in dividends. In interest income terms, this means that a 4% dividend yield gives about the same after-tax income as a 5.2–5.5% interest yield. Furthermore, investors in most provinces can earn up to $41,000 in dividends without paying tax, assuming no other income is earned.

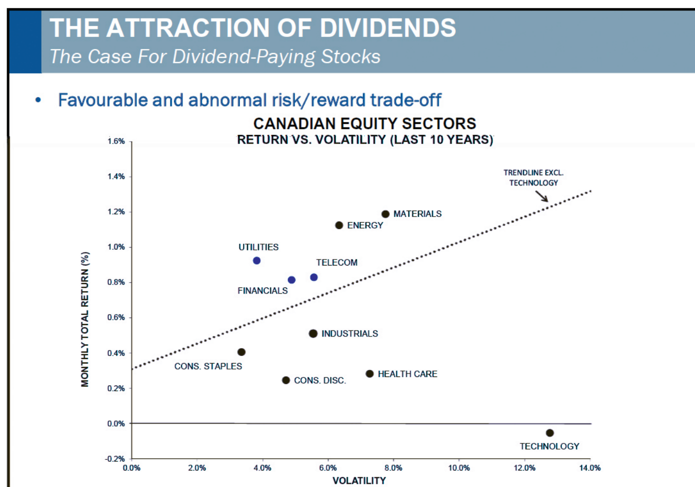
For Canadian equities, dividend paying sectors like utilities, telecoms, energy, and financials, for example, have historically performed better over the last 10 years taking volatility into account as well. Thus, the risk/reward tradeoff environment has been and still is currently favourable. (see left chart)

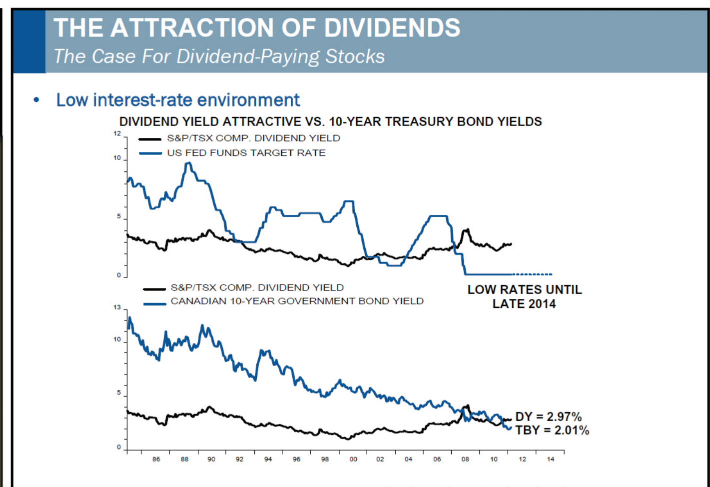
One of the more obvious reasons to own dividend paying stocks is the drastically low interest rate environment. There was a time not so long ago that investors looking for a sure thing would have T-bills and certificates of deposit (CDs) as their dominant investment tools for a safe, usually healthy return. But that's not the case anymore. Gone are the days that a retiree can rely on traditional forms of retirement income.

One of the problems is that the Bank of Canada continues to keep interest rates at all-time lows in an effort to encourage borrowing and to stimulate the economy. While this may help some businesses seeking capital for expansion and encourage consumer borrowing for cars and homes, the record low interest rates are having a negative effect on those who have saved wisely for their retirement. The low interest rates continue to encourage consumers to borrow, and penalize those who have saved money over the years. With interest rates so low, investors can't get a decent return in the conventionally "safe" investments like a money market account or T-bill.

So, dividend paying stocks have become an increasingly attractive option due to low interest rates. The stronger companies in the dividend paying community offer an annual dividend in the 3-7% range. Not only will you have the usually consistent income from the cash dividends, but also you'll be an equity stakeholder. Usually it's the better-performing companies that pay dividends, so it's likely that you'll potentially enjoy capital gains with dividend paying stocks as well. To be clear, a healthy dividend check is no guarantee that share prices won't decline, but dividend-paying companies are less volatile than their growth-company cousins and will move higher with the major market indices and with increases in their dividend payout. (see right chart)

Like anything else, when demand overtakes supply, prices generally go up. The same is true for stocks. And the demand for dividend paying stocks is expected to increase dramatically over the next 20 years as a new class of buyers emerges. Specifically, as baby boomers start retiring, the class of people who want dividend paying stocks in their portfolios will increase significantly. In fact, the 65+





population is expected to go from 21% to 39% by 2026 and historically as one's age (and needs) increase, so does risk aversion.

But we are not the first people to preach the dividend trade. This trend didn't emerge yesterday. Thus, for 2012 we and Canaccord are favouring cyclicals versus the always popular defensive dividend plays, which in our opinion have become somewhat expensive. But on any weakness, we still think there will be attractive entry points into defensive plays like utilities and telecom. Among cyclicals, we are currently favouring financials.

While it is conceivable that the flood of liquidity into global markets could cause inflation over the long term and, thus, interest rates to rise, we do not believe interest rates are likely to rise within the two-year time horizon covered by this report. Considering the weak US unemployment picture, sluggish consumer spending and business investment, and comments made by Central bankers around the world, one could argue that the slow growth/low interest rate scenario is highly probable. Finally, we believe the relative dividend yield argument is not only supported by stubbornly low interest rates, but also the expectation that companies in these sectors have the capacity to raise dividends further.

Dividends are generally very predictable. When a company declares a dividend, you can expect to receive this on the next payout. Of course, a company can change or take away a dividend at any time, but companies that pay dividends typically have more predictable earnings therefore making the dividend payouts also more predictable. At a time where there is much uncertainty in the world, why not take advantage of an investment vehicle still offering some certainty. ■

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