Dividend expectations

A roundtable discussion

THE
Great-West Life
ASSURANCE COMPANY

The panel:

Bradford Cann
Senior Vice-President, Laketon
Income (Portico)
Dividend (Laketon)

Clayton Bittner
Vice-President, GWLIM
Dividend (GWLIM)
U.S. Dividend (GWLIM)
Video

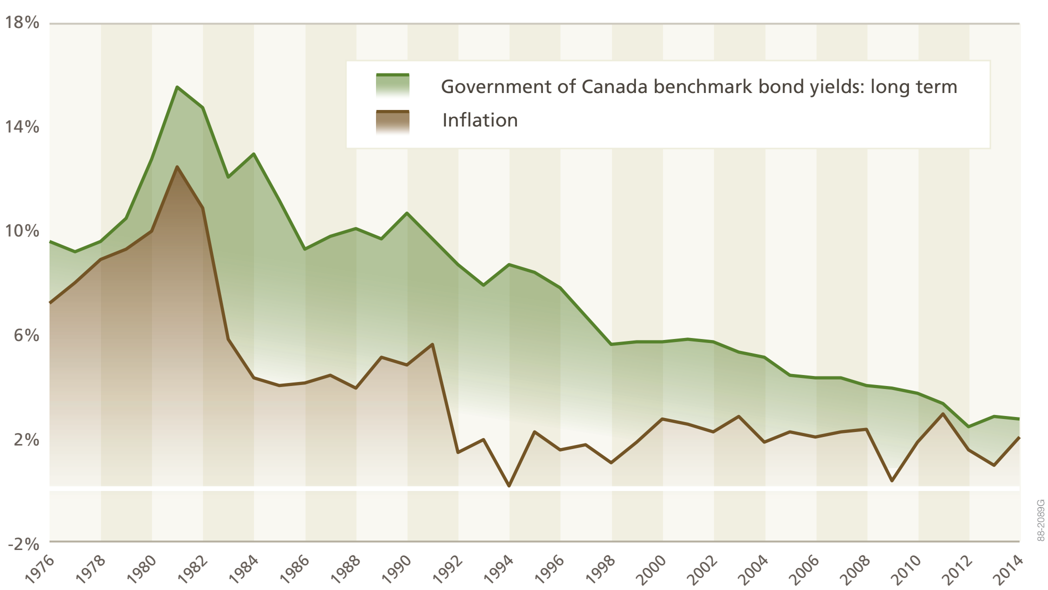
Ron Hanson
Chief Investment Officer, GLC
Monthly Income (London Capital)
Video

Alan Hickey
Marketing Director, Setanta Asset Management
Global Dividend (Setanta)
Video

Dividend investments

These are tumultuous times for investors and the increased market volatility has many on edge. Despite their wariness, it is important for most investors to remain steadfast in equities in order to stay on track with their plan. Dividend-paying equities provide a viable solution for a broad range of investors, with particular benefits for those seeking additional or steady streams income.

We recently spoke with four of our most prominent portfolio managers to discuss the benefits and trends related to dividend investing.



Source: Bank of Canada at June 30, 2015.

The experts' take

Question: What are a few of the most compelling reasons to invest in dividend-paying securities?

Ron:
I see lots of compelling reasons to invest in companies that pay dividends. For one, the consistent ability to pay (and even better, to grow) their dividend is confirmation, or at least an indication, that the company has a strong business model and disciplined management leading the charge. And from the investor point of view, a dividend stream is essentially a built-in mechanism for getting paid back your capital along with a piece of the company's earnings. In the long-term, it really comes down to the benefits of compounding. You collect income while leaving capital in place to earn even more. It also helps foster a long-term approach to investing because you want to hold onto your investment to keep 'capturing the dividend'. And on the flip side of that argument (especially when compared to a bond's fixed coupon), the capital appreciation of the stock itself can help provide some protection against inflation and loss of purchasing power.

Clayton:
The additional compounded returns from a reinvested dividend stream create both stability and ballast in down markets. Right now, if you compare it to other income-paying options like bonds, dividend-paying stocks have a yield spread over government bonds that is quite attractive, and essentially get you income plus the potential for greater long-term growth from capital appreciation.

Alan:
Central banks globally have implemented an ultra-low interest-rate environment to stave off the deflationary threats that arose from the financial crisis. This ultra-low-yield environment has driven cash and bond yields to historically low levels (and, in some cases, negative absolute levels). In this environment companies paying a dividend of three per cent plus are proving very attractive. For investors, especially those in retirement who are looking for income, they will find little in bonds and cash. In fact, as central banks start to unwind the ultra-low interest-rate policy, probably starting in the U.S. and the U.K., they may see bond prices fall as yields rise and this normally safe-haven asset may start to create losses. Property is another asset class that has relatively high yield but rising interest rates may also reduce demand for property creating supply/demand imbalances and possible losses for some property funds. Solid companies with strong financials, operating a business with a low risk of obsolescence, that have an attractive valuation and pay a plus-three per cent dividend are an attractive alternative to many income bearing assets. This is especially the case if the business can adjust its product/service pricing in a higher interest-rate environment. These are the types of companies that Setanta invests in and are looking for.

Bond versus dividend stock example:

	Year 1	Year 3	Year 5	Year 7	Year 10
Bond coupon	$200	$200	$200	$200	$200
Dividends	$200	$233	$272	$317	$400

Dividend stocks provide a growing stream of income… and much higher inflation-adjusted yield than traditional bonds.

Assumptions: Consider two investments worth $10,000 each; one in 10-year bond paying 2% while the other resides in dividend equities yielding 2% with 8% annual dividend growth.

The above example is for illustrative purposes only. Situations will vary according to specific circumstances.

Q: Asset allocation involves diversifying clients' portfolios among various investment styles and asset classes. What role do dividend-paying securities play in a balanced portfolio?

Clay:
I tend to view dividend-paying stocks as a separate asset class, falling somewhere between 'non-yield' equities and preferred shares on the equity/risk spectrum. The nature of dividend-paying companies is that they need to have stable earnings and cash flow in order to pay a dividend – and that gives them very distinct risk characteristics when compared to non-dividend paying companies. This means there are distinct correlation benefits to adding this group to a balanced portfolio, along with growth equities, small caps stocks, etc.

Brad:
I see it as a distinct asset class as well. My belief is that this class of securities should be a core part of a balanced approach to investing. And I think the allocation should be significant, say 30 to 35 per cent of the investors' equity allocation into their overall portfolio.

Ron:
The degree to which a pure dividend-paying equity fund is part of the overall asset mix really depends on the individual's risk appetite. In terms of the role dividend-paying securities play in a balanced portfolio, the dividend stream provides a partial offset to any price volatility, and the long-term beneficial results of this can be dramatic. Over the past 20 years, over 45 per cent of total returns for the S&P/TSX Composite Index and close to 40 per cent of total returns for the S&P 500 Index have come from dividends. That's 183 per cent more return for the S&P/TSX and 173 per cent more return for the S&P 500. To me, the benefits of a well-diversified portfolio are well documented. Adding that to the compounding income earned over time, and it's very compelling.

"One area of the market that we think should provide some stabilization is the financial sector at 35 per cent of the index. As a group, they are trading at or below historical valuation metrics against a modest earnings outlook of mid-single-digit growth. There are some headwinds (particularly with respect to Canadian banking operations) such as regional housing risks and the impact of low oil prices. But all in, we think these risks are quite manageable. Keep in mind the Big Five Canadian banks all have operations outside of Canada. In addition, the Big Five have an average dividend yield of four per cent, and over the past five years have grown their dividend at a CAGR of 5.9 per cent. Insurance companies will also benefit if longer-term interest rates continue to rise. While we may see some pressure on the REIT sector, we think financials are attractive on a risk/reward basis and globally financials are performing well on a relative basis."

– GLC's 2015 mid-year update and outlook
– **Ron Hanson**

Q: Considering the investment landscape, what sort of trends do you see in the future?

Ron:
I think the combination of demographics and low interest rates has caused investors to seek yield, and that's causing areas of the market to misprice risk – high-yield debt for example. At a sector level, it appears to me that the health care and information technology sectors are in a secular bull market. I also believe the financial sector looks attractive globally.

Alan:
We are seeing a growing interest in alternative sources of income and, in particular, a move away from bonds, which were considered a safe-haven asset with income. This move has accelerated recently due to the increasing probability of a change in central bank policy from one of ultra-low interest rates to a focus on getting interest rates back to normal levels. This will likely create losses for most bond holders. An alternative to bonds has been companies paying high dividends and other income-bearing asset classes like property and infrastructure.

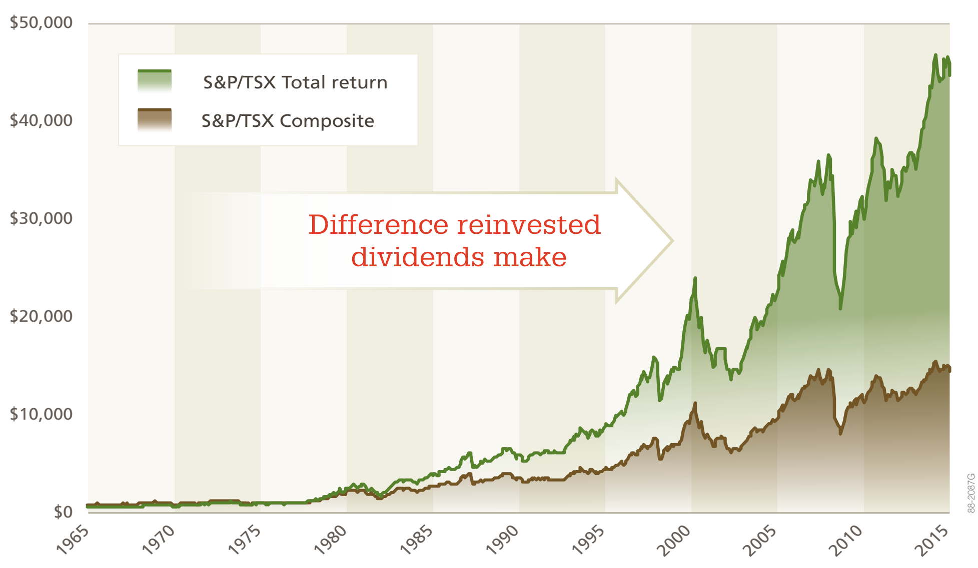
Clay:
Volatility. We are seeing much more volatility in the markets than we have seen over the past five years. Also, the potential for higher interest rates will continue to be an issue. Long term, rising rates is a necessity, but in the short term, when and how fast it happens will always be a point of discussion. So I foresee a lot of companies starting to deleverage after an extended period of low-rate-fuelled debt transactions. That will mean both price-multiple and margin compression. The desire for lower volatility is another driver supporting these types of investments.

Q: Several factors can have an impact on the price of a security; what do you look for when evaluating a dividend-paying security?

Clay:
Essentially, I want to see four things: stability, sustainability, growth and value. Stability: of industry, business, underlying earnings and cash flow. Sustainability: I want to know that the payout is not at risk and that the dividend payments are not in excess of earnings generation. Growth: I like to see growing dividend payouts that are supported by company and industry fundamentals to support long-term growth and offset potential inflation. And finally, value: I do not overpay for trends or fancy stories.

Brad:
Ah – looking for the "secret sauce", are you? Essentially, it is a mix of a several ingredients. Starting with the basics – but not to be understated – I like to know the company has a track record of paying dividends. I look at the management's track record of "doing what they say/tell investors". I want to see a strong balance sheet with reasonable debt levels so that they can weather inevitable economic downturns and continue with dividend payments. I also want to see how competitive the industry is, and what the norms are in valuation (e.g., where are we, has it changed and since when). So I'm looking at industry structure and dynamics, which would allow for reasonably good returns for the given risks inherent in the industry. Finally, something we can't ignore is the interest-rate environment, which essentially tells us where the competition for money will be.

Alan:
Within our global dividend strategy, we search for companies that exhibit a combination of low financial risk, low operational risk and low valuation risk. In addition, we look for companies that have the capacity and commitment to pay dividends and we look for those companies with sustainable dividend pay-out ratios (i.e., the dividend can continue to be paid despite business, industry or economic shocks).



CAGR	5 years	10 years	15 years	20 years
S&P/TSX Total Return	8.3%	6.9%	4.9%	8.4%
S&P/TSX Composite	5.2%	3.9%	2.4%	6.0%

Source: Bloomberg at of June 30, 2015.

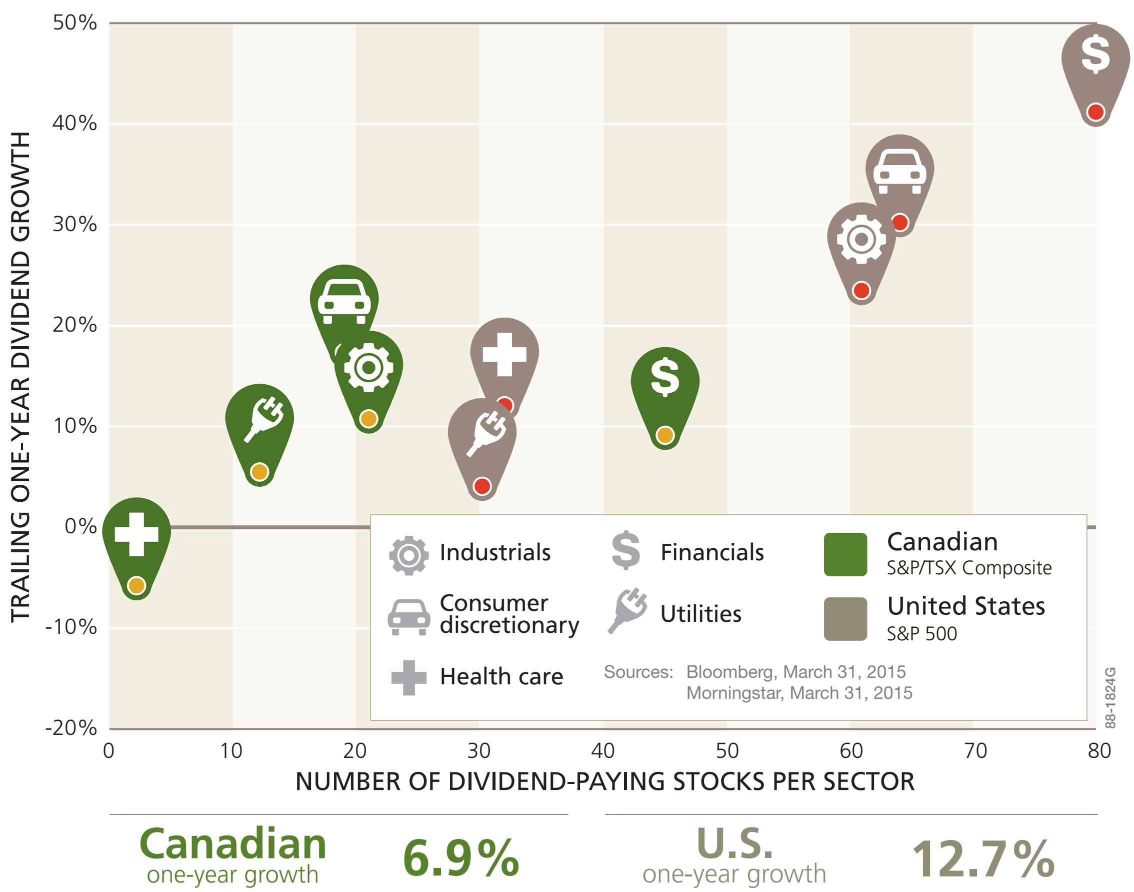
We like to see companies grow their dividend and we generally look for companies with a dividend yield of three per cent but will also consider companies paying a lower dividend if we think the company is attractively valued and if we think the dividend can get to three per cent over time.

Q: Within your area of focus, what industry sectors do you currently find most attractive?

Clay:
Financials, particularly insurance companies and some select banks, are looking attractive. I also see opportunities in the cyclically-depressed industrials sector, and within the information technology sector I like more of the large-cap names. These areas of the market have been beaten up from cyclical weakness, but they have attractive multiples, strong cash flow and emerging dividend growth. Currently, within North America, the U.S. has many opportunities simply due to the size of the universe, but you need to be able to weigh out the additional volatility of this much more "hedge fund active" market.

Brad:
I like the banks and insurers. I believe there are opportunities in Canada's wireless telecommunication companies, and I see some strong energy companies that will survive the current poor energy pricing environment to eventually come out on top.

Alan:
Our valuation process is stock specific. We use a value-oriented bottom-up approach and we are long-term investors and look to invest for three, five or more years. While our global dividend mandate does not target specific regional or sector weights, we seek to maintain a sensible level of diversification across all sectors. However the fund has a tendency to have a significant weight in Europe and the U.K. as companies domiciled in these regions have historically paid out higher dividends. We look for a balance in the portfolio by sector but we also want to purchase companies that have strong financials as this limits downside and helps the dividend to be maintained in times of stress. Currently, the top three sectors in the fund are financials, telecom and health care with 16, 13 and 12 per cent respectively.



Did you know?

Canadian dividend investments are subject to tax breaks.

Check out this handy **calculator** to see your potential savings.

Q: What are typical yields you're finding on Canadian, global or U.S. dividend-paying stocks?

Ron:

The ranges are very wide and vary by sector. It's also not meaningful to look at this in isolation without looking under the hood at these dividend-payers. Many companies (especially within the energy sector) have yields pushing 10 per cent, but the sustainability of these dividends is very much in question and the market may already be pricing in dividend cuts in certain instances. Canada has higher average yield than the U.S., likely due to the greater financials sector weighting and also due to our high energy sector weighting (of note, currently many energy names with extended yields are pricing in possible cuts due to weak energy prices). The U.S. average yield is lower, but the market offers far greater options due to the number of securities and sub-sectors available to us. Currently, our monthly income fund offers a yield of 3.1 per cent.

Brad:

Currently in Canada we are able to find from four to 4.5 per cent yields on the banks; from three to five per cent on energy names; from three to 3.5 per cent on insurers; and from three to five per cent on selected utilities. So compared with current interest rates, these are generally attractive, but with a caveat that interest rates appear poised to rise, so the advantage may weaken/lessen somewhat over the next 12 months.

Alan:

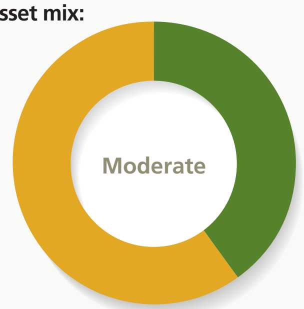
Our universe is seeing from two to five per cent versus a dividend yield of just over two per cent in the MSCI World Index. From a regional perspective, Europe still has strong dividend-paying companies and hence occupies just over half of our portfolio. Currently, our global dividend mandate has an internal yield of circa 3.7 per cent.

Incorporate dividend funds into an overall portfolio

Moderate

20% Core Bond (Portico)
20% Corporate Bond (Portico)
30% Income (Portico)
10% Dividend (GWLIM)
10% U.S. Dividend (GWLIM)
10% Global Dividend (Setanta)

Asset mix:

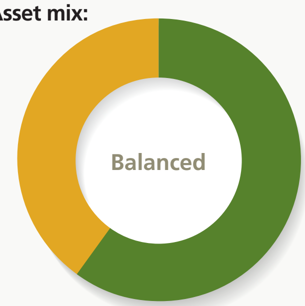


60% Fixed income 40% Equities

Balanced

15% Core Bond (Portico)
15% Corporate Bond (Portico)
25% Monthly Income (London Capital)
15% Dividend (GWLIM)
15% U.S. Dividend (GWLIM)
15% Global Dividend (Setanta)

Asset mix:

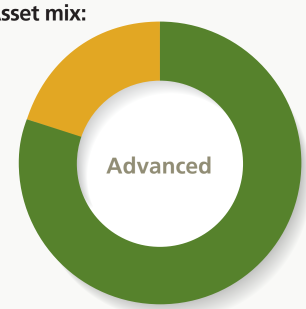


40% Fixed income 60% Equities

Advanced

10% Corporate Bond (Portico)
20% Monthly Income (London Capital)
20% Dividend (GWLIM)
25% U.S. Dividend (GWLIM)
25% Global Dividend (Setanta)

Asset mix:



20% Fixed income 80% Equities

For illustrative purposes only.

We've provided this information for financial security advisors only. These commentaries were provided by the fund managers and are presented only as a general source of information. The views expressed are current as of Aug. 31, 2015 and are subject to change without notice. Performance data is provided for illustrative purposes only and represents past performance, which is not necessarily indicative of future performance.

A description of the key features of the segregated funds policy is contained in the information folder. Any amount allocated to a segregated fund is invested at the risk of the policyowner and may increase or decrease in value.

This fund is available through a segregated funds policy issued by Great-West Life.

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