# BTSX Welcomes Bond Refugees

David Stanley

It is amazing to me to see how many of the 'fast money' crowd are stampeding into the dividend school of investing. Mind you, they almost seem to require hogtying before they will embrace this successful, tried-and-true method. They can be heard to mutter, "Well, if nothing else is working…".

Perhaps it is because they are loath to forego the pleasure of pouring over momentum charts looking for that next RIM (or as I call it 'the round-trip stock'). Or maybe they miss the thrill of seeing their gold stocks dropping another 10% and the joy of paying commissions on all the trades they've made.

But, there is a second group of investors who genuinely deserve some compassion, and I mean that contingent who, as a result of being horse -whipped during the 2000 tech-wreck, and maybe again in the 2008-20?? Great Contraction, have sworn off equities as being an invention of Beelzebub and have chosen to reside forevermore in the land of Fixed Income.

Sadly, they are now faced with two immediate problems, the first being replacement risk, meaning that when previous meaty yields disappear as their bonds and GICs mature they are looking squarely at replacing them with issues that often have sub-zero real yields. Further erosion of their purchasing power can be expected if inflation continues in excess of the Bank of Canada's 2% target, as it did in 2011. It seems to me that the best way to negate these threats is by investing a portion of one's portfolio in Canadian blue chip high dividend stocks. In this column we will explore that possibility.

For those investors who are leery of equities let me first discuss some of the risk factors thought to be associated with owning stocks. Volatility is often, but incorrectly in my view, considered identical to risk. General market volatility has increased dramatically in the past few years as every fresh tidbit of economic, political, and business-specific news produces a paroxysm of knee-jerk reaction. The reason is simple; world stock markets ceased to trade on fundamentals several years ago when the depth of the debt abyss opened by marauding bankers free to act in an unregulated workplace became known. The good news for dividend investors is that volatility can be largely discounted as a risk factor. Whether the price goes up or down, blue chip companies continue to pay dividends and in practice these dividends tend to dampen price gyrations.

Let me illustrate this point. Beta is a measure of a stock's volatility in relation to its index. The index is given a beta of 1.0 and individual stocks are ranked according to how much they deviate from the market average. A stock that is more volatile than the market over time has a beta above 1.0 and vice versa. So, beta for the S&P/TSX Composite Index is 1, but the average beta for our current 10-stock Beating The TSX portfolio is 0.73. This can be compared to 2.16 for RIM.

Volatility is not a significant risk factor for most dividend investors. As it happens, recent research has shown that low beta stocks actually outperform high-beta stocks (http://www.quantitativeinvestment.com/documents/LowVol_Sigma_DEV_2012_NLB%20v10.htm). The authors conclude that, "high-beta stocks consistently underperform low-beta stocks, both across time and across countries".

The second risk factor of stock ownership is that of lower returns by not taking dividends into account, and I think this is a real risk. Estimates of how much dividends boost total returns vary considerably depending upon the time period chosen, the index being examined, and whether the dividends are being reinvested. Jeremy Siegel, author of 'The Future For Investors: Why the Tried and True Triumph Over the Bold and the New', says that

dividends, including reinvestment, account for 97 percent of the historical Dow 30 Index stock returns.

Other studies (e.g. http://www.advisorperspectives.com/newsletters11/Dividend_Dynamics.php) quote lower figures for the S&P 500, 54% in this example.

Let's look at Canadian examples. One of my co-contributing editors, Norm Rothery, has presented data (http://www.ndir.com/SI/articles/MS0510.shtml) from a study of Canadian dividend stocks showing for the period 1977 to 2007 that those in the top yielding 30% group outperformed those in the lowest yielding 30% group by a factor of over 3 (annual returns of 15.9% vs. 5.1%). The market average was 12.4% annually. A $1000 investment in our own BTSX highyield portfolio in 1987 grew to $12,112 by December 2011, as compared to only $7,252 for the TSX Total Return Index. I continue to give examples of the outperformance of dividend stocks in my columns, although by now the amassed data from a large number of studies can leave no doubt as to the truth of that proposition.

The third risk factor is ignoring the power of compounding dividends. Again, dividend reinvestment is a well-accepted method of building wealth. Compounding, by which we mean in this context the ability of an asset to generate dividends that are then reinvested in order to generate their own earnings, can be done easily and inexpensively with many Canadian blue chip stocks through dividend reinvestment plans or DRIPs. The compounding effect becomes more pronounced as time goes on, thus explaining the benefit of the buy-and-hold philosophy for individual investors. Returns multiply without adding any additional funds to the investment other than plowing back the dividends. To ignore dividend reinvestment is to discount one of the most powerful tools available to individual investors. I recommend The Drip Investing Resource Center website (http://dripinvesting.org/Default.htm) containing the message boards of another of my co-contributing editors, Bob Gibb ('Opera Bob'). It is a wonderful site to start learning about

Canadian DRIPs. It seems to me that the best time to buy a dividend stock and start compounding the dividends was the day you were born and the second best time is now.

The final risk factor is the overarching risk taken when purchasing any type of investment, a permanent loss of capital. It is the word 'permanent' that becomes tricky; for a day trader maybe that means hours or days, but when using a buy-and-hold strategy the investment horizon extends to years and maybe decades. As investors we need to know ourselves well enough to estimate how much risk we are willing to accept and for how long a period of time. Our

'Beating The TSX' approach has performed well in down markets. Table 1 provides the comparisons for all years in which the total return index was negative.

**Table 1.**
**Performance of BTSX in down years vs. Index.**

| YEAR | BTSX | INDEX |
|---|---|---|
| 1987 | -10.54 | -12.45 |
| 1990 | -11.65 | -11.65 |
| 1992 | -1.49 | -3.58 |
| 1998 | -13.55 | -5.41 |
| 2001 | 2.90 | -6.73 |
| 2002 | 2.63 | -7.09 |
| 2008 | -17.71 | -27.90 |
| 2011* | -0.51 | -7.30 |
| AVG. | -6.24 | -10.26 |

**Through March 30, 2012*

I think it is possible to conclude with reasonable certainty that our method will beat the index in years when the index drops. It is interesting to note that the index only went down in consecutive years once (2001-2002), and that for the 25 years this portfolio has been in place the index was negative for eight of those years. Another advantage of the BTSX strategy is that it combats valuation risk (the risk of buying stocks when they are expensive) by using a selection technique that identifies companies with high dividend yields, implying that the price is low. It also only considers the Canadian blue chip group of companies, those that are most likely to continue and increase their dividends.

### Here is a summary of the potential benefits to bond refugees of investing in dividend stocks:

1. Canadian large cap blue chip stocks that pay significant dividends have out performed the index by a wide margin in good times and bad. As the 'New Normal' era described by Bill Gross of PIMCO continues to unfold, characterized by low investment returns, low

interest rates, slow growth, and rising inflation, dividends will play an even greater role in total returns. Safety will become more important to equity investors, and companies that pay dividends are regarded as having stronger financial discipline than those that do not since dividends need to be paid out not only this year but into the future.

2. Dividend investing is appropriate for those investors currently looking for an income strategy. Dividend stocks can provide a steady income stream independent of fluctuations in interest rates. A meaningful dividend helpsto stabilize stock prices during times of high volatility. Dividends can supply income or be reinvested as the investor's needs dictate.

3. High yielding stocks can be found in many sectors of the Canadian economy and thus can provide diversification to an equity portfolio.

4. Qualifying Canadian dividends are taxed at a lower rate than interest income in nonregistered accounts.

5. Unlike bond interest rates that are fixed, dividends can increase. Generally, dividends are increasing more slowly now than in the past decade, but a number of Canadian stocks are continuing to raise their dividends even in this investment climate. For a list of them go to http://www.moneyshow.com/investing/article/1/GI_PortStrat-23574/Canadas-New-Dividend-Growth-Stars/. Also, more Canadian companies are starting to pay dividends.

6. Dividend investing is, or should be, a buy-and-hold process. This provides time for reinvested dividends to compound and keeps investing costs to a minimum. It requires little time or effort and no sophisticated financial knowledge. In my opinion selecting a Canadian blue chip dividend portfolio is much easier than mastering some of the skills needed to be a successful fixed income investor. The tools necessary to empower individual investors are readily available; I recommend both the *Canadian MoneySaver* and ShareClub membership as good starting points.

7. There are, certainly, other courses of action open to bond refugees. Purchasing futures contracts, holding precious metals, buying real estate, gems, works of art, emerging market debt or stocks, etc. are all possibilities, but would someone whose goal is safety and who, by nature, is a conservative investor choose such options? I think it is unlikely since equities themselves are sufficiently daunting. While it is true that the risk of a material loss is higher with equities than with Canadian government bonds or GICs, the likely possibility of a prolonged period of low interest rates and resulting sub-zero real returns of fixed income investments tips the odds in favour of dividend stocks as far as I am concerned.

I'm not suggesting that you immediately sell all your fixed income products and jump into a dividend stock portfolio, but if your income stream could use a boost you might consider this investing technique. There are several approaches to explore including mutual funds, ETFs, and individual stocks. If stock ownership appeals to you try http://www.canadianmoneysaver.ca/tt_benefits_pub.aspx and have a look at my introduction to the very simple Beating The TSX methodology available free for subscribers at the *MoneySaver* website. Perhaps this is the year that you become empowered to be your own financial advisor.

As always, I hope this column will generate discussion and I will attempt to answer your questions within the guidelines set by the *Canadian MoneySaver*.

*David Stanley, PhD, Rockwood, ON DavidS5209@aol.com*