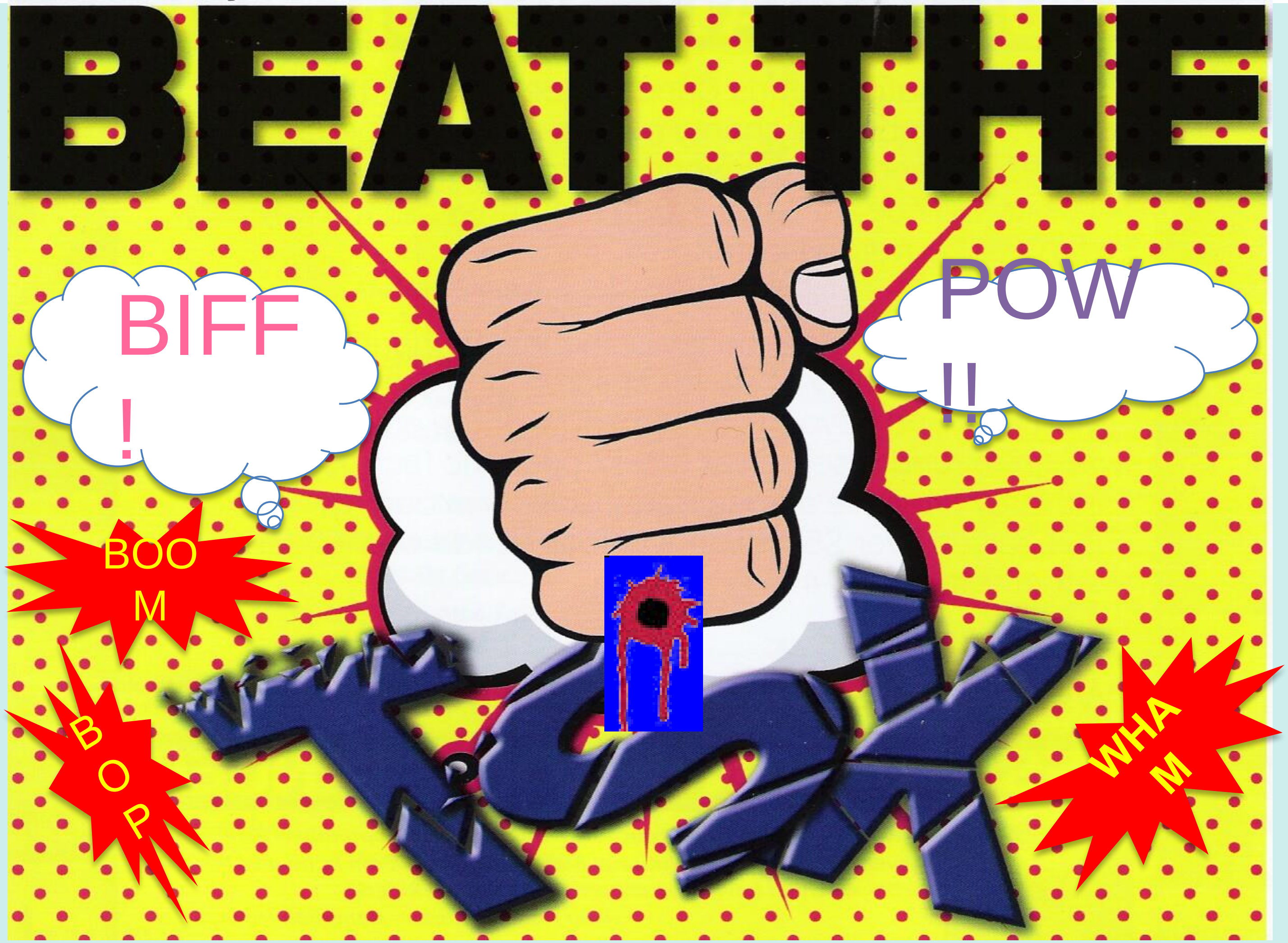


Beating The TSX – It Works!

Toronto CMS Conference

David Stanley © 2014

Thanks for coming. I gave my first CMS talk here in 1997, 17 years ago. Yet, today the title is the same and so is the message.

<u>Outline</u>

1-Outlook for Canadian investors

2-What is a blue-chip stock?

3-Why invest in Canadian dividend stocks?

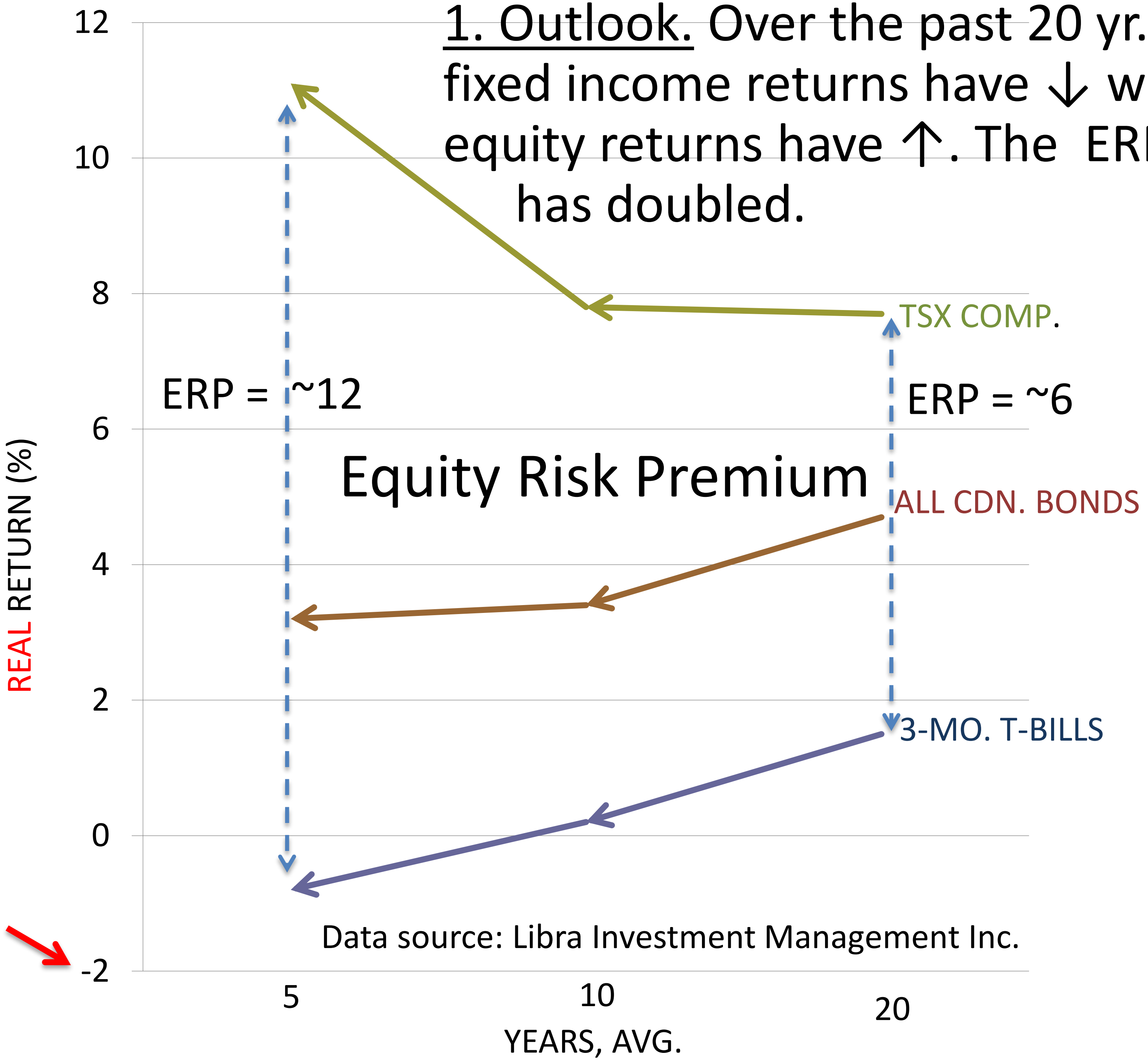
4-Investing for total returns

5-What is ‘Beating The TSX’?

6-How does it work? How has it performed?

7-Conclusions

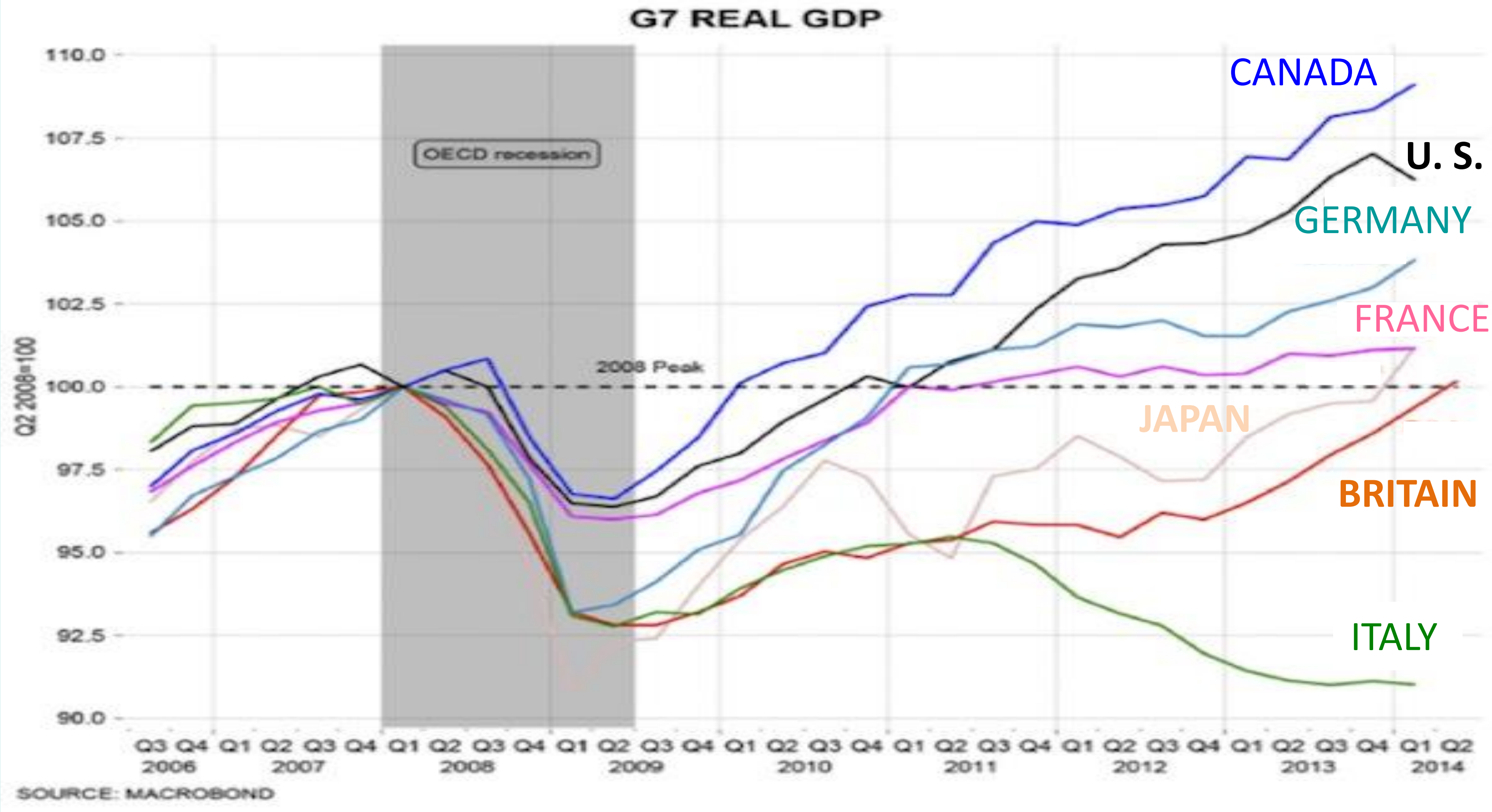
<u>1. Outlook.</u> Over the past 20 yr. fixed income returns have ↓ while equity returns have ↑. The ERP has doubled.



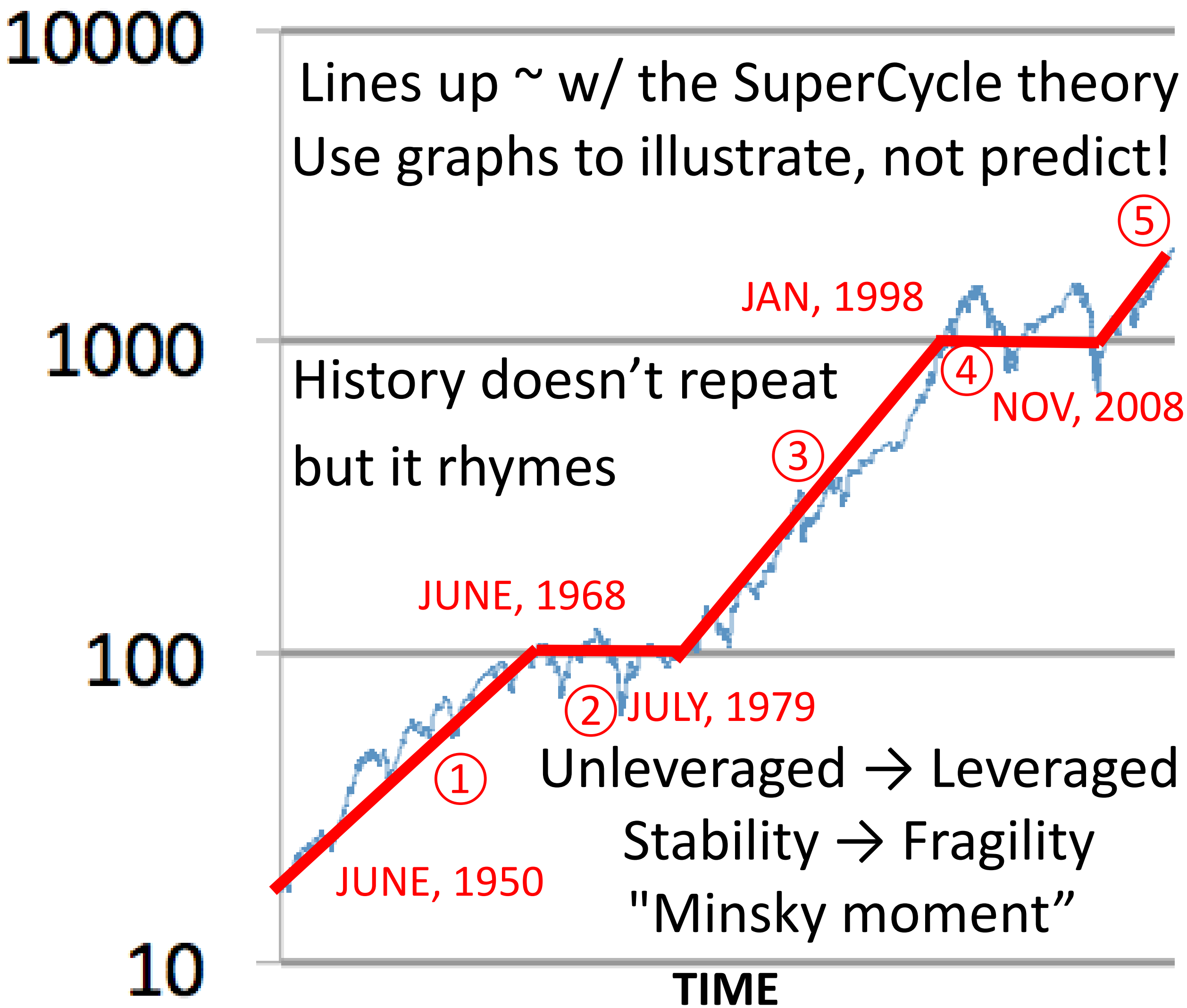
Equity risk premium (ERP) is the amount by which an asset's expected rate of return exceeds the risk-free interest rate. It is the extra return above and beyond the risk-free interest rate that investors demand to invest in equities as a class. The number rises when investors are more fearful than hopefully and vice versa. ERPs are very high now, mainly because treasury rates are very low. Historically, ERPs are usually 4-6, now they are ~10-12. Current ERPs are unsustainable. The market is overpriced. And, what happens when interest rates move back up?

That is the risk. The catch is that right now there is no other place for investors to put our money and get any kind of return. So we are obliged to take the risk. But, when will interest rates move back up? I think later rather than sooner. Growth is lagging in both the U. S. job and housing markets. This ‘new normal’ U. S. economy remains too indebted, and investors should be skeptical, cautious, and defensive. Dealing with increasing risk in the market should be our first priority at this point; also geopolitical, aging, debt, and housing bubble risks.

The Canadian C. D. Howe Institute predicts real returns of 0.5% on long-term bonds and of 4.8% on stocks. For a balanced portfolio, this means a real return of 2.7% for Canadians. Buttonwood, the Economist writer, quotes a U.S. hedge fund as saying "Future real returns from a stock/bond portfolio may be barely positive." So, we need to get used to just receiving what our equities and bonds pay us. We should make sure that our investments pay us as much as possible, consistent with our risk tolerance. This is the short-medium term view, what about the medium-long term outlook? A little better, I think.



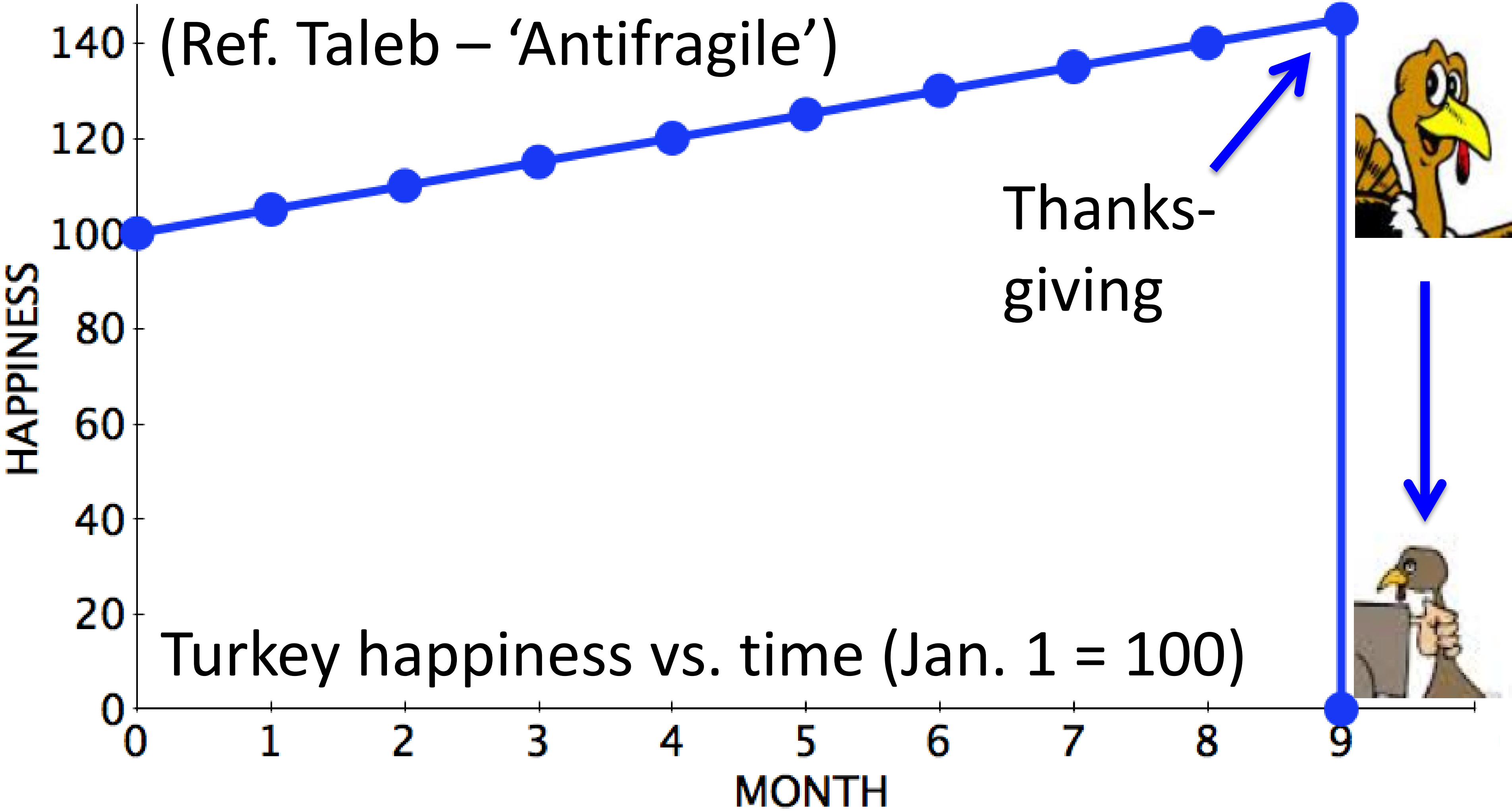
GDP is improving faster here than in other G-7 countries. We have a diversified and developed economy founded in foreign trade and responsible for about 45% of GDP. We are a net exporter of energy.



Long-term view

Leg	Yrs.	CAGR
1	18.5	10.2
2	11.2	0.2
3	18.5	12.9
4	10.8	-2.7
5	5.8	17.1

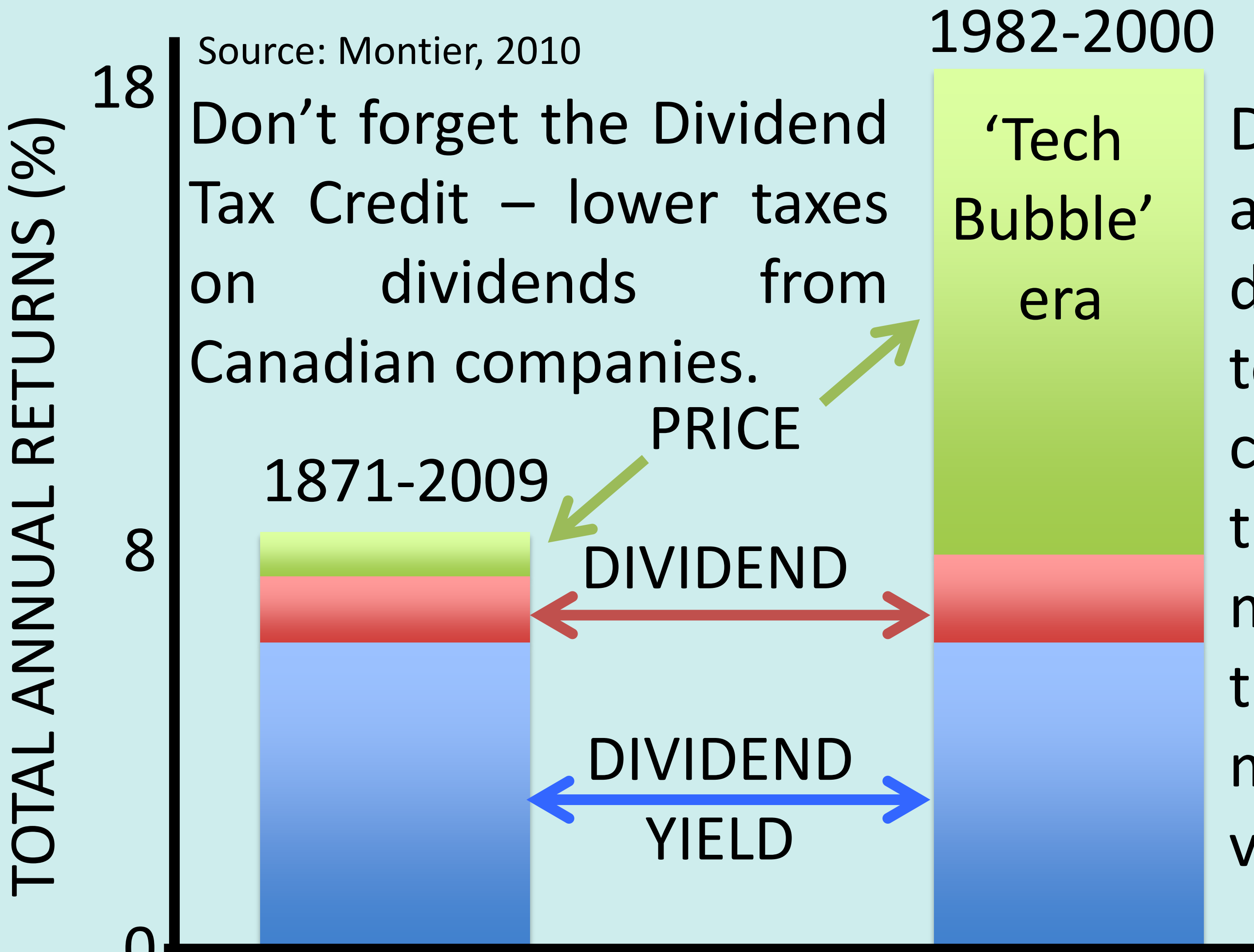
Log plot of S&P 500 from 1950 to 2014. 5 distinct legs. If this holds, we are starting a new up cycle that might last another 12-13 years. Very speculative!



Or, is this investor happiness vs. time, 2014? Neither group can predict the future, but humans worry and turkeys don't. Don't panic, but if you do, be first.

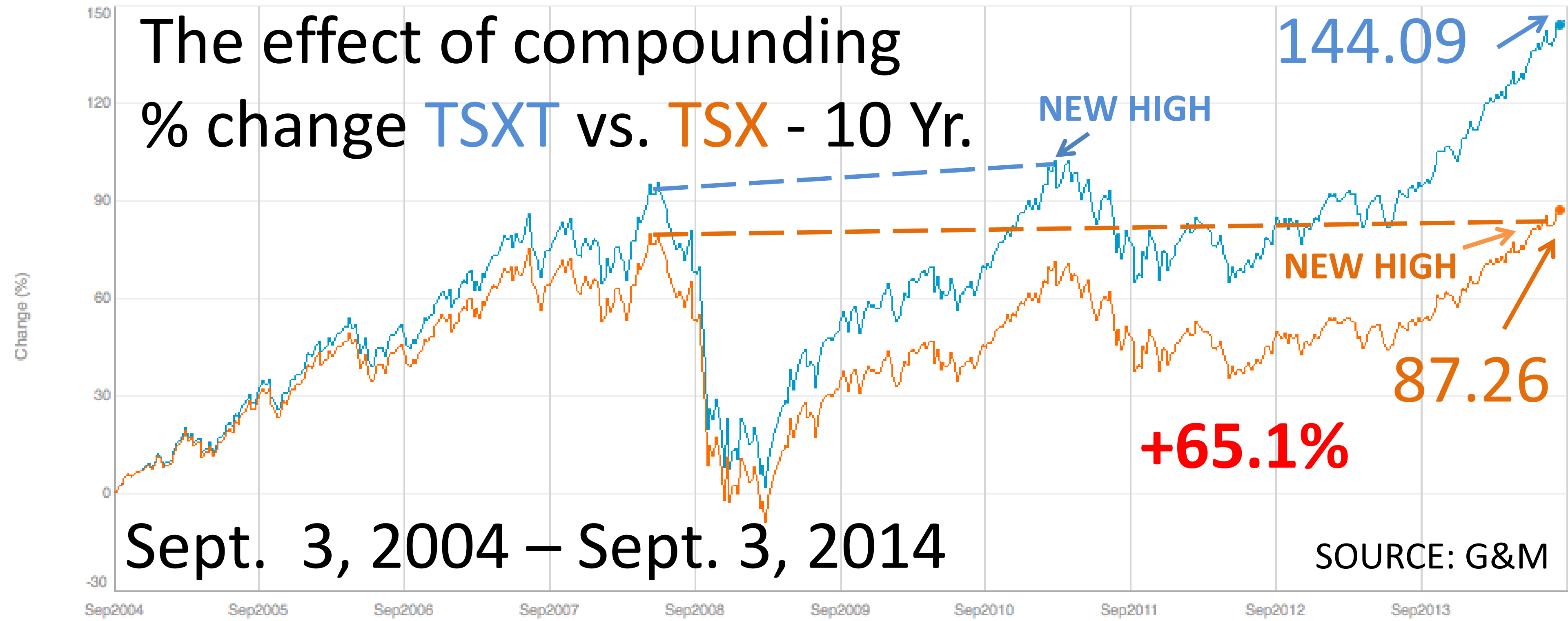
2. What is a blue-chip stock? Stock of a large, well-established and financially sound company that has operated for many years. It has a high market capitalization, is generally the market leader in its sector, and is a household name. They have a record of paying rising dividends for many years. Their boring reputation is certainly not deserved, since there is nothing more exciting than making a profit. Profit is what blue chips are all about. If you choose them wisely and hold them for decades they can provide your family with ever-increasing streams of dividends.

3. Dividends. We invest in dividend-paying stocks to take advantage of the steady, increasing payments and the opportunity to compound our returns by reinvesting the dividends to purchase additional shares of stock. Blue-chip companies are financially healthy and raise dividends over time. The stock prices of these companies tend to be less volatile than the market in general, a lower β. They have lower risk than companies that do not pay dividends and that have more volatile price movements. How important are dividends to total returns of stocks?



DRIPing allows dividends to compound, thus making them much more valuable.

The importance of dividends (S&P 500). On average, over the very long term, dividends (yield + growth) have accounted for close to 90% of the total return.



These indices (Composite & Total Return) are non-investable. Plain vanilla ETF's are the best way to go, unless you want to try beating the index. The return on these ETF's should be the index gains minus the small MER. But, you can't beat the index with an ETF.

Which is best for total return investing?

4. Total return investing. "For all long-term investors, there is only one objective – maximum total returns after taxes.” Sir John Templeton

Total returns equal capital gains plus dividends and/or interest. We should also consider costs, inflation, taxes, etc. Let’s take a look at the best way to invest for total returns. Should we purchase mutual funds, ETFs, or individual stocks? This is a confusing problem for individual investors since we are continually bombarded by marketing campaigns trying to direct us to mutual funds.

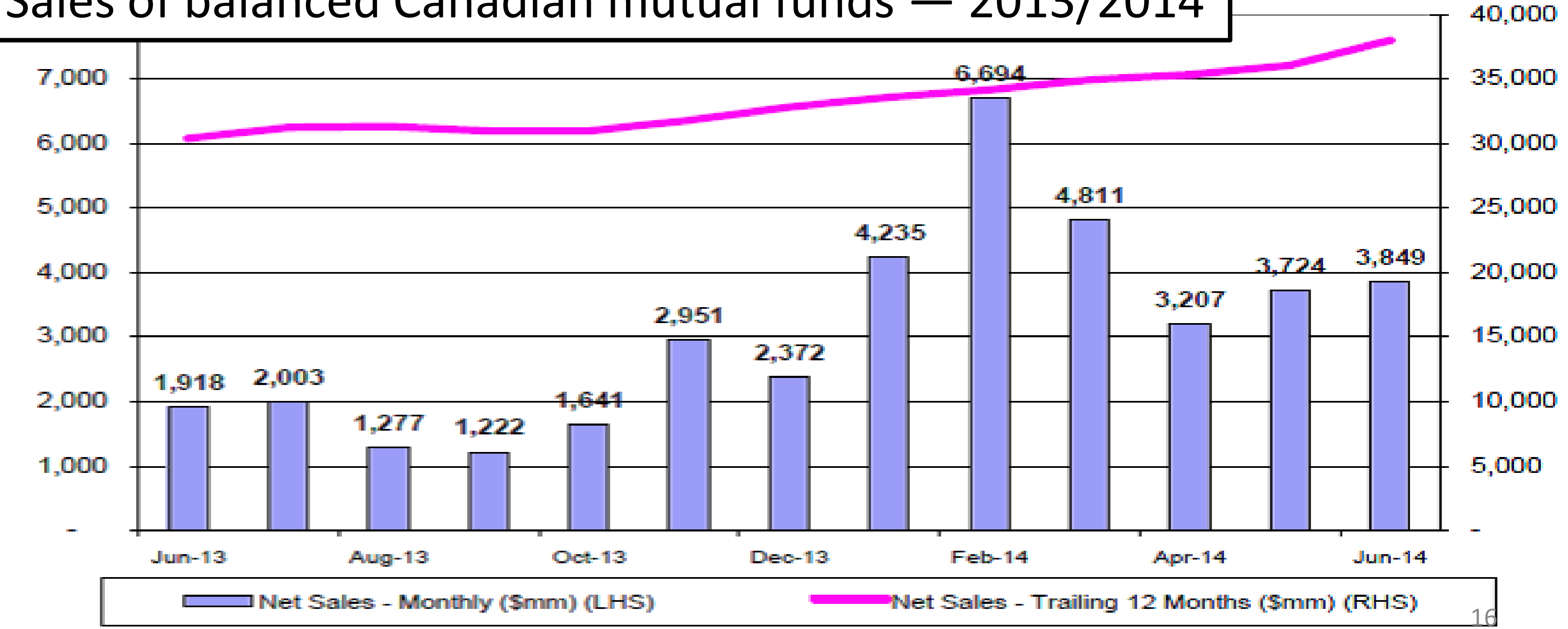
What's happening to Canadian investors now?

*Low interest rates; inflation is creeping up (~~2.4~~ 2.1%)

*This is every retiree's worse nightmare

*What to do? Some have been purchasing 'balanced' mutual funds and taking on more risk. Why?

Sales of balanced Canadian mutual funds — 2013/2014



When the U. S. Fed said the QE program of buying bonds would taper, thus leading to ↑ interest rates, Canadians cashed in their bond ETFs and began purchasing balanced mutual funds (actively managed products that juggle the ratio of stocks, bonds, and cash in an attempt to maximize total returns). Results showed balanced funds leading the sales of mutual funds in Canada, up over 100% compared to June 2013. While total ETF assets rose 18% Y-O-Y, and the number of ETFs reached ~~301~~ 400, ETF assets still represent only 6.4% of total fund assets.

Have these Canadian balanced mutual funds rewarded investors? (Top 20 out of ~ 900)

Top 20 Cdn. balanced mutual funds vs. XIU			
Time	20 Funds	XIU (?)	All funds
5-Yr. ann. tot. ret. (n=20)	14.01%	11.07%	10.0%
10-Yr. ann. tot. ret. (n=7)	7.56%	8.79%	4.9%
Avg. MER	2.03%	0.18%	2.6%

As of Apr. 30, ’14; Jan. 31, ‘14; source: CMS June, ‘14, G&M. Active vs. passive — investors never learn.

Active funds that beat the index (SPIVA, 2013)

Fund Category	1 year	3 year	5 year
Canadian Equity	72.73%	45.65%	30.36%
Cdn Small Cap	68.97%	42.86%	25.53%
Canadian Div.	58.62%	3.13%	0%
US Equity	18.97%	1.45%	2.35%
Intl Equity	27.27%	8.11%	11.36%
Global Equity	13.19%	3.74%	8.26%
AVG.	43.3	17.5	13.0

The majority of active managers underperformed their benchmarks. Impossible in advance to predict which will outperform. John Bogle, Vanguard, 1974.

How about ETFs? The only ‘balanced’ ETFs (2) are combinations of other ETFs in an attempt to achieve a balance of equity and fixed income components. The ETF passive model doesn’t align very well with an actively balanced mutual fund where the ratios of stocks to bonds to cash are always being altered. Perhaps a future ETF might be designed to compete in this market. An ETF that puts 50% into a S&P/TSX 60 total return index (XIU) and 50% into a laddered GIC index could be a start. Or you can make your own easily enough.

What about stocks? Are we forced to buy balanced mutual funds with their high MERs or can we construct our own portfolio of stocks that will do even a better job? So, I put together a group of 9 Canadian and U. S. blue-chip stocks that I currently own. I have owned all these stocks for at least 15 years. It has been difficult for investors to find total return data. Now there is a website (longrundata.com) that gives annualized total returns, the growth of a given dollar investment, annualized dividend growth rates, and 30-year annual dividend histories.

Annualized total returns (ATR)					Ann. div. gro. rate		Current
SYM	START	END	ATR (%)	$1,000	5 YR. (%)	10 YR. (%)	YIELD (%)
ENB*	06-Jul-95	22-Jul-14	18.29	$24,571	13.81	19.77	2.54
TD*	22-Jun-95	22-Jul-14	16.08	$17,235	6.54	17.61	3.33
BCE*	16-Jul-95	22-Jul-14	15.81	$14,500	26.15	14.54	5.01
NA*	30-Oct-96	22-Jul-14	15.47	$12,821	7.07	19.06	3.96
CAR.UN*	15-Jul-99	22-Jul-14	12.53	$5,895	1.03	-1.51	5.10
JNJ*	08-Oct-97	22-Jul-14	9.98	$4,945	7.61	10.84	2.74
POW	27-May-99	22-Jul-14	8.90	$3,646	0.87	16.87	3.65
EMA*	15-Sep-98	22-Jul-14	8.46	$3,626	7.87	20.71	4.19
TA*	06-Jul-95	22-Jul-14	3.64	$1,978	1.44	8.78	5.67
http://longrundata.com/		**AVERAGE**	**12.13**	**$9,913**	**8.04**	**14.07**	**4.02**

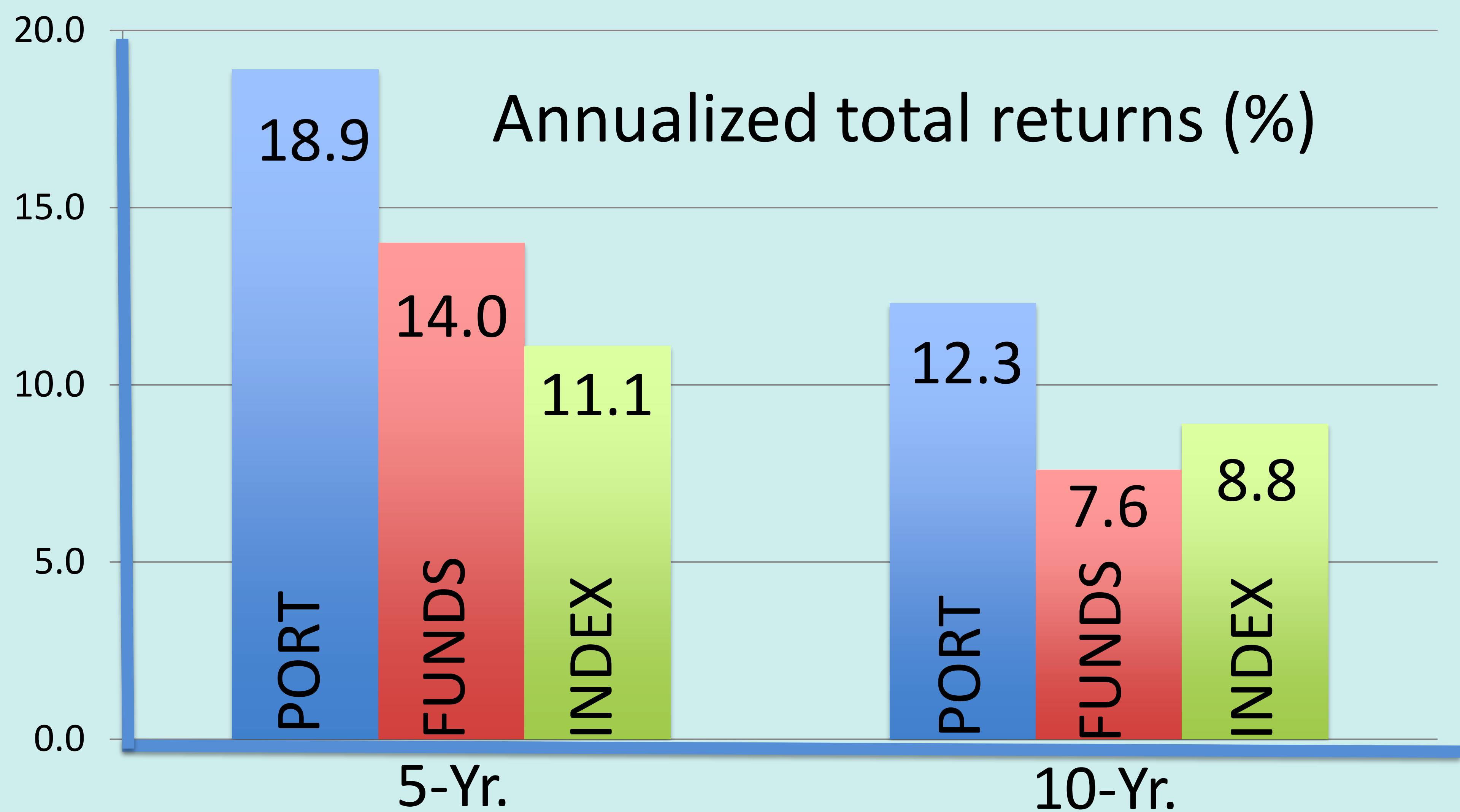
It doesn't take many 10-baggers to make a successful portfolio. ENB ATR/CAGR=18.29%! XIU yield = 2.53%; BOC 10-yr. bond = 2.11%, CPI = 2.1%, * = DRIP plan

This portfolio has produced very good results. Next I constructed a high-dividend portfolio to compare with the mutual funds. The aim is to achieve high total returns. If we were to have a portfolio of only stocks, they should be stocks with healthy dividends to make up for the lack of fixed income. The best sectors to invest in for dividends are **T**elecoms, **U**tilities, **R**eal estate, and **F**inancials, the **TURF** stocks. Although I normally include **P**ipelines in utilities, here I have split them into a separate category. I own or have owned all 13 of these stocks.

Table 1. Annualized total returns of a 13-stock high dividend portfolio.[1]

Company	Symbol	5-yr Ann. TR	10-yr Ann. TR
Fortis*	FTS	11.92	10.90
Emera*	EMA	16.45	10.67
TransAlta*	TA	-2.34	2.91
Cdn. REIT*	REF.UN	23.43	18.96
Cdn. Apt. REIT*	CAR.UN	18.29	12.89
H&R REIT*	HR.UN	26.17	12.28
BCE Inc.*	BCE	20.14	10.98
Telus*	T	26.97	16.99
T-D Bank*	TD	21.74	12.85
National Bank*	NA	20.65	11.86
CIBC*	CM	18.27	8.57
Enbridge*	ENB	27.39	19.20
TransCanada*	TRP	16.07	10.84
AVG.		18.86	12.30
Balanced MFs		14.01	7.56
XIU		11.07	8.79

[1]5-year (beginning April 30, 2009) and 10-year (beginning April 30, 2004) annualized total returns through April 30, 2014. Data from longrundata.com. *=DRIP plan

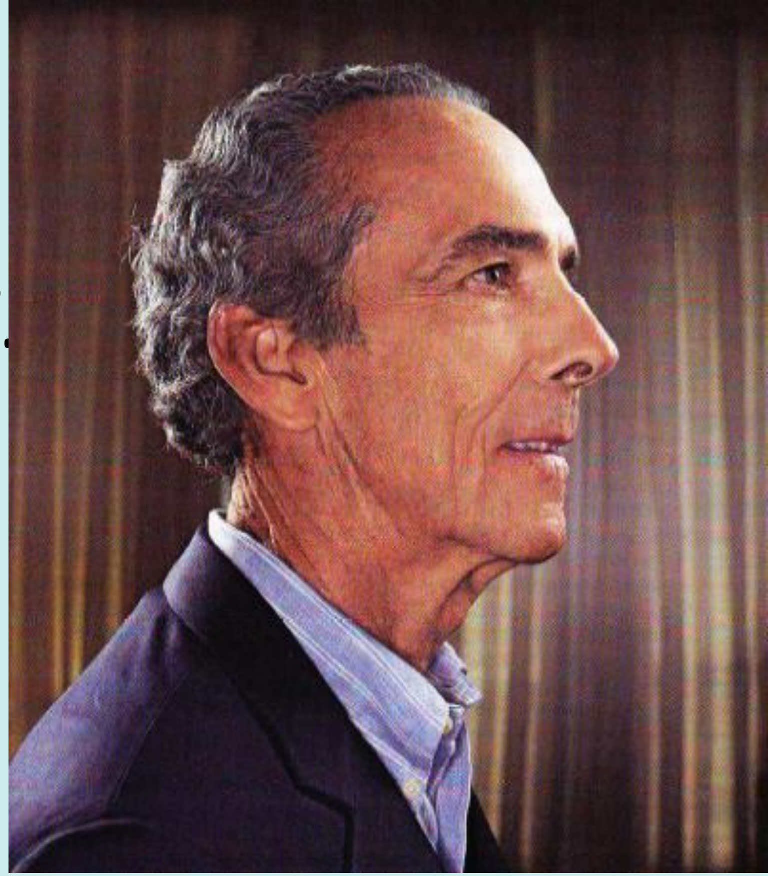


Significant outperformance by our portfolio over top 20 balanced mutual funds. It has been difficult <u>not</u> to make $ over the past 5-10 yr., even with black swans.

Our ‘small’ collection of high-dividend stocks out performed by quite a wide margin the total return average of the top 20 Canadian balanced funds for both 5 years and 10 years. In fact, this group topped 19 out of the 20 mutual funds in 5-year returns and all 7 of them in 10-year returns. Thus, individual investors have a choice of either purchasing a high MER balanced mutual fund that may or may not produce adequate returns, or setting up a portfolio of high-dividend blue-chip Canadian stocks and holding for a reasonably long time.

5. BTSX

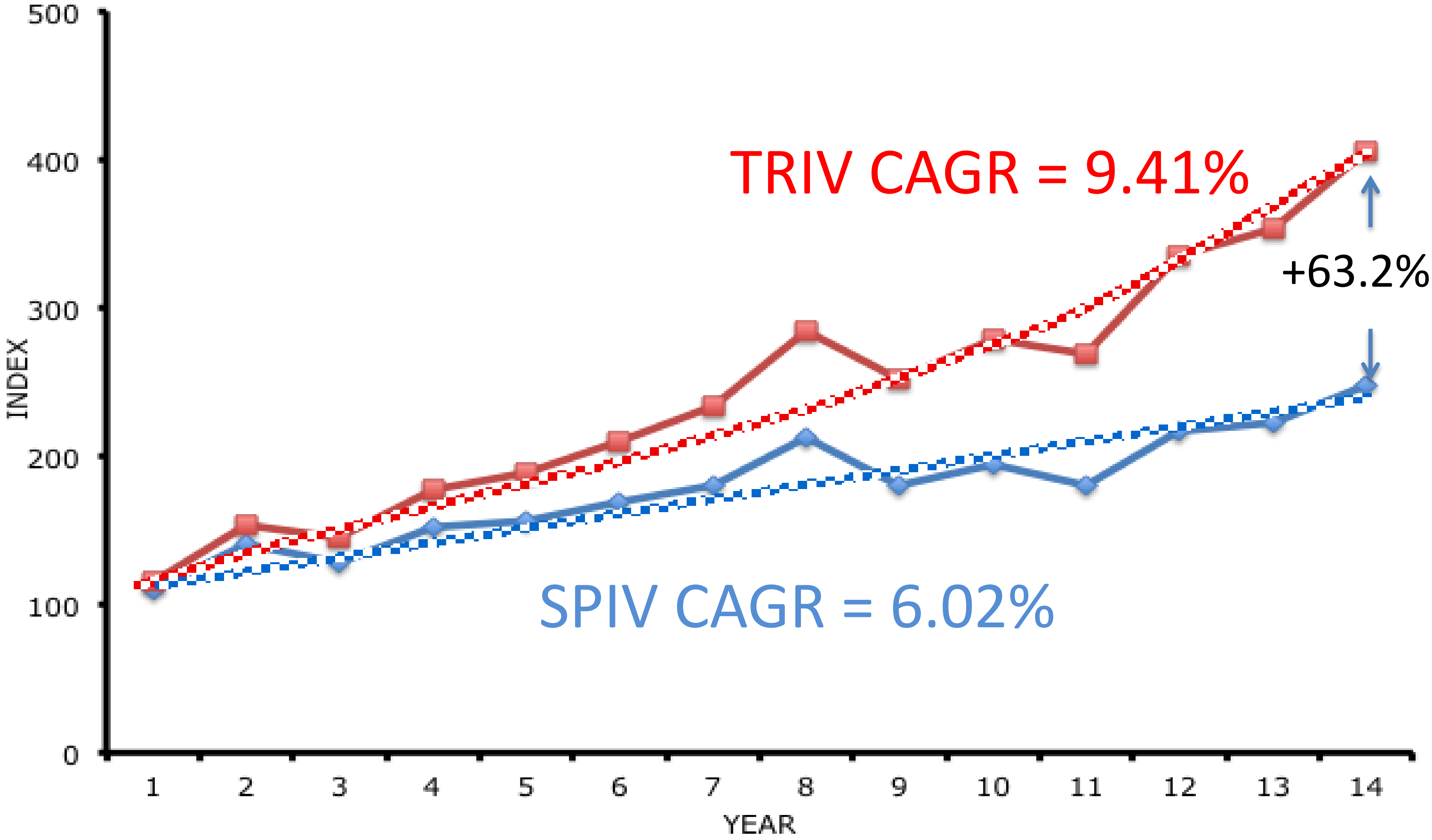
In 1991 Michael O'Higgins wrote a book called "Beating The Dow". 'Dogs Of The Dow' uses an emotion-free method to select high-dividend stocks. From 1974 till 2012 (38 years) BTD has averaged 11.7% vs. 9.1% for the S&P 500 index, an increase of 29%. O'Higgins' book became an instant investment classic and served to get me interested in dividend investing.



Michael O'Higgins

After I took early retirement in 1995 I looked at the stock price and total return data for the TSE35 blue-chip index. I was struck by how much the total return index with its reinvested dividends had outperformed share price appreciation. I adapted the structured decision-making process of BTD to the TSE and wrote my first ‘Beating The TSE’ column in 1996. Dale Ennis

I have always been thankful for the encouragement of Dale Ennis, who, with his wife Betty, founded the Canadian MoneySaver in 1981.



TSE35 Index 1982-1995. Note the effect of compounding (+63%). This was the start of BTSX.

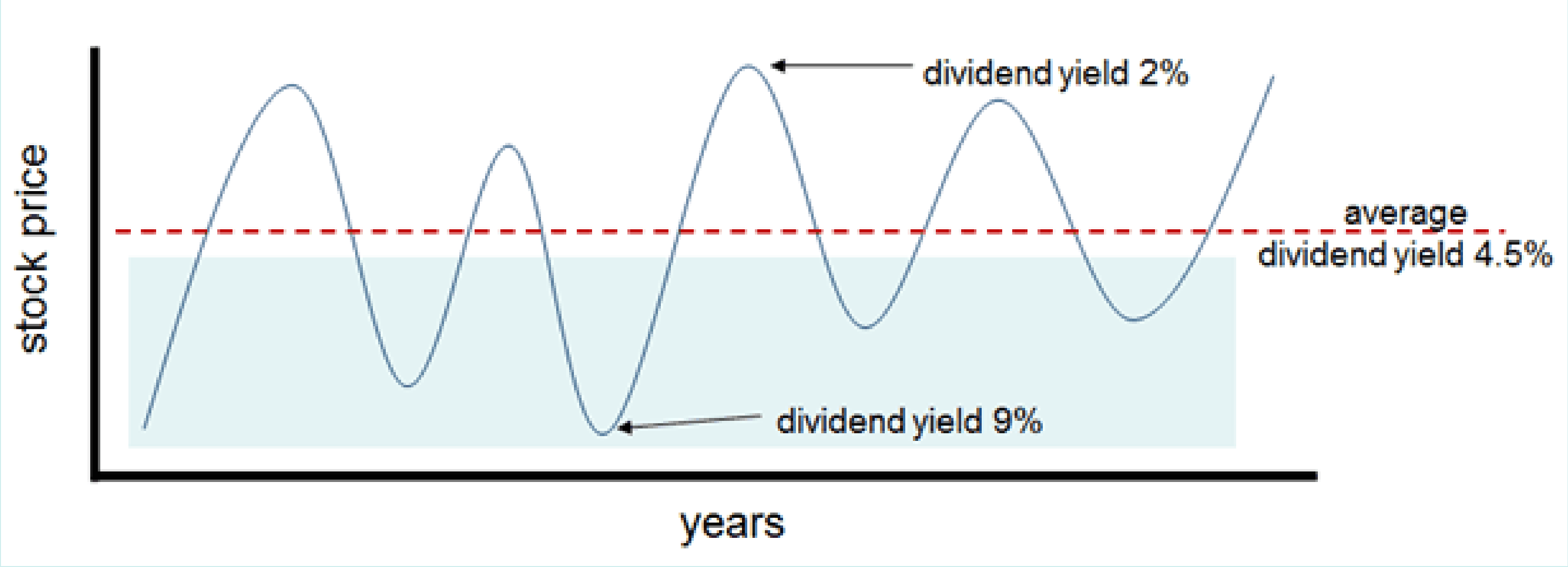
Implementation? The list of S&P/TSX 60 stocks is ordered from high to low by dividend yield, the top 10 stocks* are then ordered from lo to hi price. Stocks are purchased in equal dollar amounts and held for ≥1 yr. Investors build up a portfolio of high quality stocks purchased at a reasonable cost. No secret sauce, hocus pocus, animal spirits, etc. “I reject all forms of prediction-based investing.” (J. DeGoey, CMS), and I agree. I don't trust any investment scheme whereby some human-based prediction has to come true before I make money. BTSX is passive & contrarian.

*Former income trusts are not included in the list from which I select the portfolio. Why not? For BTSX, BTD, or any similar method to work, the index must be composed of <u>only</u> ‘blue-chip’ stocks. The ‘blue-chip’ designation requires both a very large market capitalization and a very long history of paying out stable & rising dividends. Prior income trusts don’t currently qualify for ‘blue-chip’ status. The TSX60 is much too large to be a true Canadian blue-chip index. If the DJ 30 Industrials works in the U. S. why do we need 60 in Canada? The old TSE35 Index was better.

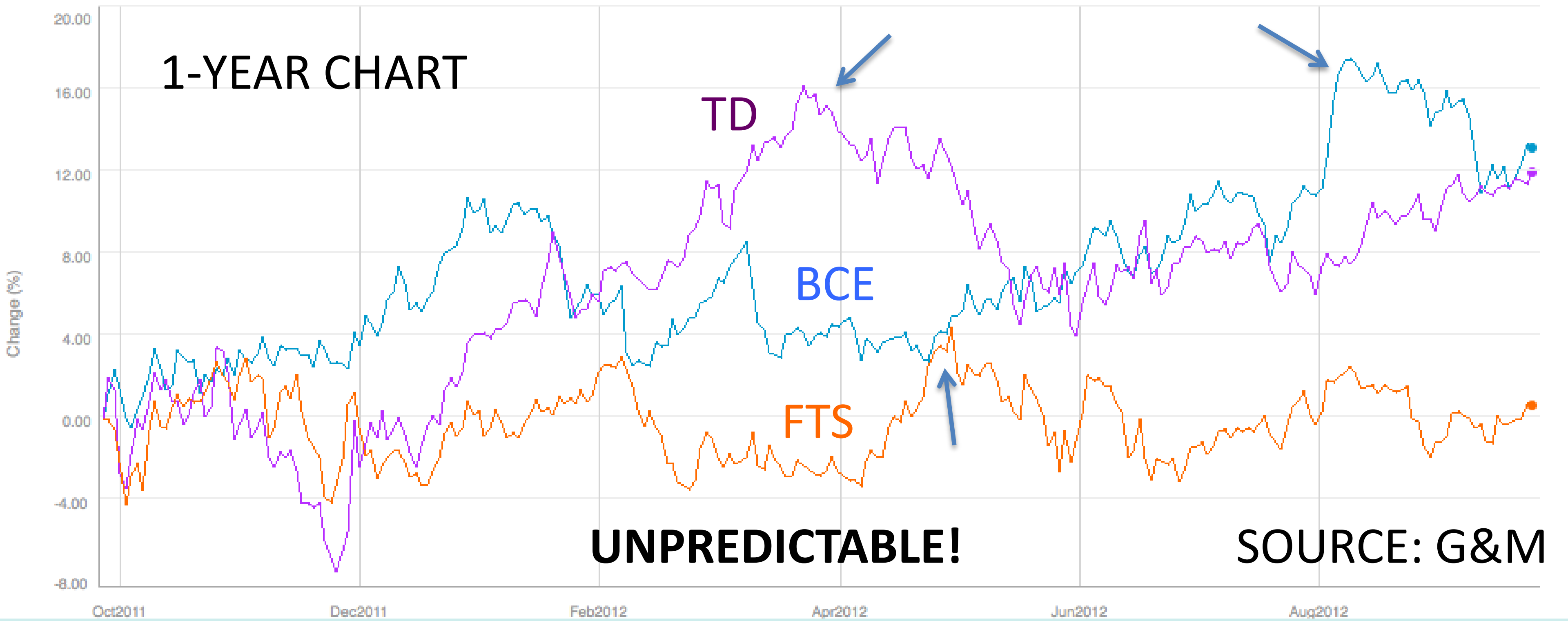
6. How does BTSX work?

A. Stock price and yield are inversely related if the dividend is constant.

$$\boldsymbol{DIVIDEND\ YIELD = \frac{ANNUAL\ DIVIDEND\ PER\ SHARE}{STOCK\ PRICE\ PER\ SHARE}}$$



B. Even low β blue-chip stocks show significant but unpredictable cyclicality over time.

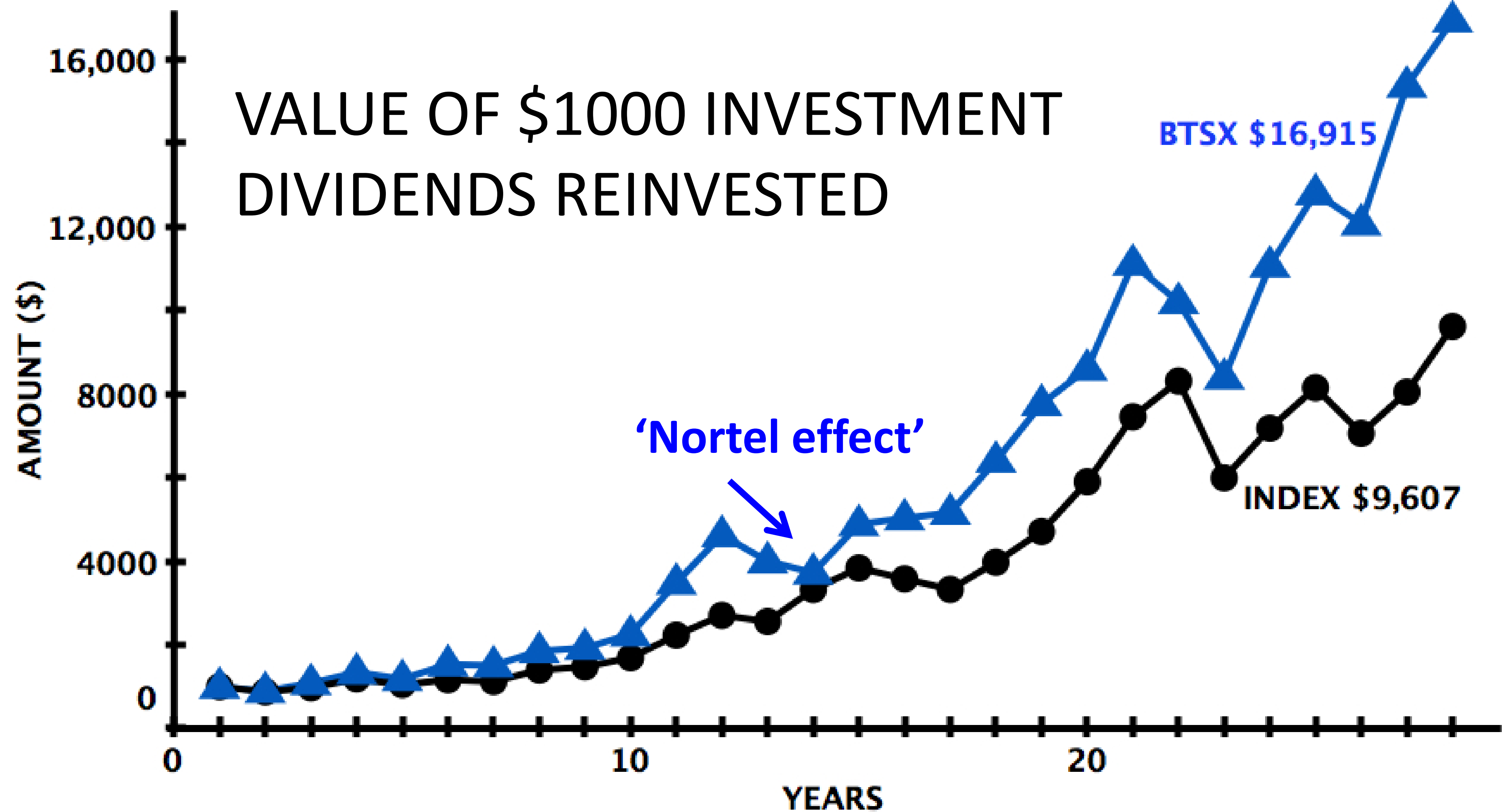


Select stocks when yield is high and price is low. <u>We are simply efficiently exploiting small but favourable valuation shifts in low β stocks</u>. How to pick the low?

How has BTSX performed?

BEATING THE TSX – 27 YEAR RESULTS (1987-2013)		
	AVG. RETURN (%)	$1K INVEST
BTSX	12.47	$16,915
TR INDEX	9.89	$9,607
% INCR. VS. INDEX	+26.1	+76.1

A 26% increase in return is huge. BTSX has trounced all comparable mutual funds & ETFs, beat the TR index 70% of the time for the past 27 yr., 83% for the past 6 yr. The second column shows the effect of dividend reinvestment.



76% advantage for BTSX. Record so far is 19 beats, 1 tie, and 7 losses vs. index total return. Value of $1000 invested in 5-year GIC's for same period = $4243.

Beating the TSX — 'real' returns

25-YEAR RETURNS, $1000 INVESTMENT, CPI = 2.29%				
	VALUE	CAGR (%)	'REAL' (%)	NET VALUE
BTSX	$12,064	10.47	8.18	$7,140
TR INDEX	$ 7,051	8.13	5.84	$4,133
5-YR. GIC	$ 4,243	5.95	3.66	$2,456
BTSX/GIC	$ 8,154	8.21	5.92	$4,298

Even a cautious investor who used a 50/50 split between BTSX and 5-yr. GIC's would have still beaten the index after CPI.

The objective mechanism of BTSX is simple and easy. Stocks often stay on the list for several years, so low turnover and trading costs. Usually stocks drop off the list because the price has risen. You can keep them as part of a growing portfolio of blue-chip dividend stocks, many having DRIP and SPP plans, acquired at a reasonable cost. Long holding times are necessary for dividends to compound. Thus, BTSX is a buy-and-hold strategy. It is much easier and less risky to accumulate wealth slowly. You don't need to be a financial or mathematical wizard to be successful.

Advantages of the BTSX system:

*No broker, financial advisor, but it can beat the TSX

*No mutual funds, MERs, or market timing

*No time consuming research, but get compounding

*Low-risk, less stress, independence, passive

*Acquiring high yielding Canadian blue-chip stocks at a reasonable cost that you hold for a long time

Disadvantages of the BTSX system:

*No one to blame but yourself

*Dividend cuts, tax code changes

*Index itself — Laidlaw (-94%) 1999

Is this a truffle-hunting pig, or could this be our Prime Minister trying to nose out even more ways to squeeze money from seniors/investors by increasing taxes on dividends? See Maclean’s Sep. 15, p. 38.

‘A strategy for all seasons’

An important advantage of the BTSX system is that it is well-suited for both accumulation and withdrawal phases of investing. In the accumulation phase dividends may be reinvested in DRIPs to capture the advantages of compounding, while in withdrawal phase dividends can supply income. The % of BTSX stocks vs. fixed income can be varied as needed. The correct ratio is one that allows you to sleep. It is often easier to make money than to hold on to it. Dividends help you hold on to it.

2014-15 BTSX PORTFOLIO, MAY 24, 2014 (NOT TODAY'S LIST)	YIELD (%)
†TransAlta TA* (0.280, 1911) (β, YEAR FOUNDED)	5.36
†Shaw Comm. SJR.B (0.317, 1966)	4.07
Power Corp. POW (1.026, 1925)	3.90
Fortis FTS* (0.351, 1987) † = REPLACEMENT (LOW TURNOVER)	3.92
†Sun Life SLF* (0.762 1865)	3.88
Rogers Comm. RCI.B (0.207 1925)	4.01
†National Bank NA* (0.865, 1859)	3.96
†BCE Inc. BCE* (0.247, 1880)	4.93
†Bank of Montreal BMO* (0.909, 1817)	3.99
†CIBC CM* (0.970, 1867) AVG. β=0.593, AGE=114 YR.	<u>3.97</u>
(NO EX-INCOME TRUSTS OR REITS. * = DRIP & SPP PLANS)	AVG.= 4.20
AS OF 10/11/14 S&P TSX 60 TR = -1.15%, BTSX = +0.88%	XIU = 2.53

Are there any safer investments? You can buy GOC bonds but you assume the risk of low/negative returns after taking inflation into consideration. Current GOC 2-yr. bond has a 1.05% yield, but CPI is higher than that, so you have a negative return. In the current economic reality we must take on more risk to get an acceptable return. I think the 'New Normal' will continue, but I see the BTSX strategy as the most palatable of the alternatives open to Canadian investors. It combines income, buy-and-hold, contrarian, and passive styles with compounding.

What can we do now? First, be grateful we are Canadians, living in a country where banks are better regulated, where we are not mired in political upheaval, and where the rule of law is deeply ingrained. No country has melded compassionate democracy and capitalism better than Canada. We must increase our risk exposure when real interest rates are low. Many of us need more income and this means taking on more risk – increasing equity allocation, or investing in pref. shares or company bonds instead of GICs or GOC bonds.

‘PASSIVE’

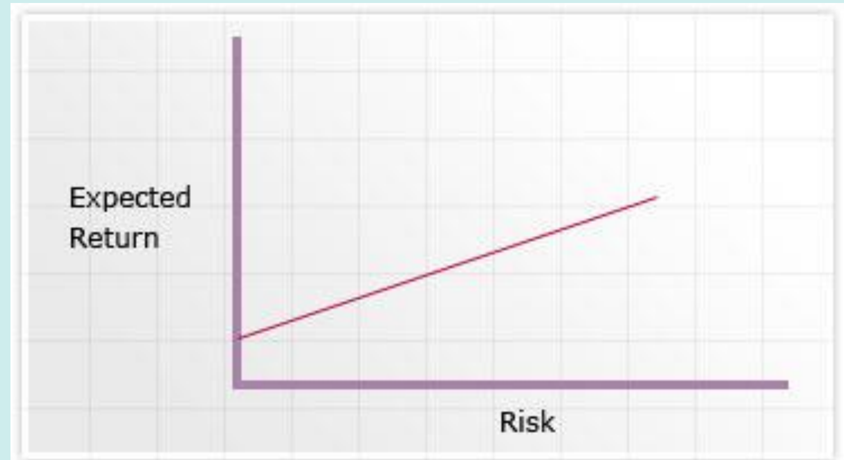
LOW β STOCKS, INDEX FUNDS, ETFs, BTSX, BLUE-CHIP DIVIDEND STOCKS

RETURN

‘FOCUS ON THE RISK OF LOSS NOT THE REWARD OF GAIN!’

(Taleb – ‘Antifragile’)

DAY TRADING, MARKET TIMING, MUTUAL FUNDS, OPTIONS, DERIVATIVES, HIGH β STOCKS



OLD CONCEPT

‘ACTIVE’

RISK

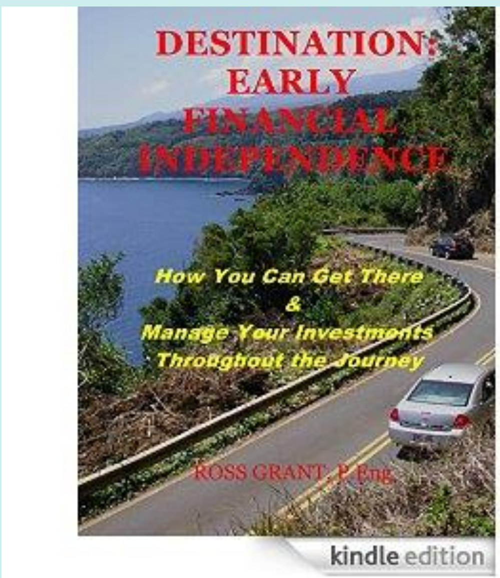
The new risk/return continuum

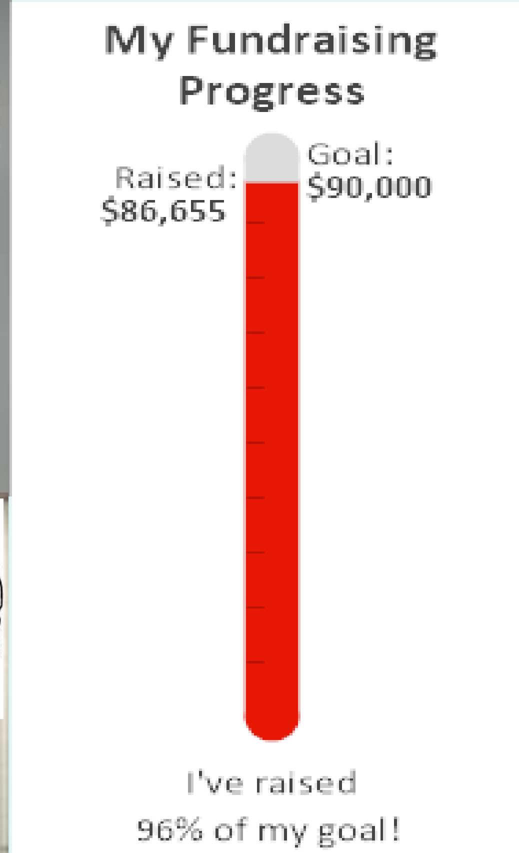
7. Conclusions

A portfolio of Canadian blue chip, high yielding stocks with reinvested dividends is the safest strategy. Add some REITS you will outperform the index. Save, avoid debt, expect higher taxes, work longer, and be content with less during retirement. Educate yourself. The Canadian MoneySaver and ShareClubs are a good start. These are almost the same conclusions I arrived at in 1997. “The purpose of investing is not to simply optimize returns and make yourself rich. The purpose is not to die poor.” William Bernstein

Ross Grant retired at 43 by following investment information in the Canadian MoneySaver magazine. He has published as an e-book, ‘Destination: Early Financial Independence’, to pass on his investing experience (CDN$ 5.99, Amazon.com) “This book lays down the distilled real life wisdom of someone who achieved very early retirement.” Gail Bebee

I am very pleased that Ross will be carrying on the BTSX column tradition in the CMS.





Let’s help Peter reach his goal! It’s for the kids!!

http://searsnationalkidscancerride.com/


THANKS FOR COMING
AND THANKS FOR YOUR
SUPPORT OVER THE PAST 18
YEARS!