Investing In Canadian Dividend Stocks

(Part 2)

By David Stanley

In my previous article I provided some background on dividend investing. This time I aim to provide you with the information you need to begin your own investment plan. Our strategy is simple; a simple portfolio of high-yielding Canadian blue-chip stocks has been shown to outperform the index in good times and bad. As an example, over the two-year period from May 2008 to May 2010, during which Canada experienced the biggest financial shellacking since the Great Depression, our portfolio gained 4.6% while the total return index lost 18.1%.

How can individual investors begin a dividend portfolio? There are three main ways: mutual funds, exchange-traded funds, and purchasing shares of the common stock in companies. Let's look at these options.

First, mutual funds. Mutual funds are the easiest way to invest in stocks, but also the most expensive in the long run. The idea behind mutual funds – that individual investors pool their resources and place them in the hands of an investment professional who then selects and actively manages a portfolio of stocks designed to outperform the market average – is not a bad one in theory. But, unfortunately, in application the costs associated with active management including trading costs, management expense ratios (MERs), and other fees, mean that very few managers (less than 10% on an after-tax basis) actually outperform the market average and those who do are impossible to identify beforehand and rarely outperform for any length of time. There are also tax implications since the government defines a trade as a taxable event and turnover is often quite high in mutual funds as managers seek to improve their return.

To be fair, mutual funds have the advantage of taking all responsibilities and decision making out of the investor's hands (if you consider that an advantage). If you have absolutely no interest in investing and no time to devote to your investments but still want to have equities in your portfolio (and someone to blame other than yourself if things go wrong), there are a multitude of mutual fund salespeople eager to accommodate you. And a multitude of mutual funds – about 200 fund companies and thousands of funds available in Canada.

Focusing on Canadian dividends, we find over 300 mutual funds devoted to just this sector, i.e. funds that invest in dividend-paying stocks. Let's see how they have performed (Table 1).

Table 1. Average returns of Canadian dividend mutual funds.[1]

	MER[2]	1 year	3 years	5 years	10 years
Avg fund	2.3%	9.9%	-4.6%	2.0%	5.9%
TSX TR[3]		12.0%	-3.9%	5.5%	3.3%

[1] As of June 30, 2010. Average annual compound returns, with reinvestment of distributions. Data source: globefund.com
[2] Management Expense Ratio
[3] S&P/TSX Total Return

Not a very pretty picture is it? In three out of the four time periods the average fund underperformed the index. One has to pity the poor mutual fund manager who enters the competitive arena of stock selection with a 2.3% millstone around his neck. Now, when the market is rising and skies are sunny investors barely notice mutual fund fees, but in the dark days of our recent downturn they become all too apparent. So, what is your market forecast for the next 5 years? Mine is middle to low single-digit returns, meaning that fees will take a big chunk of your profits. One of the first rules in investing is to keep expenses as low as possible, below 1% if you can.

Let's move on to exchange-traded funds or ETFs, the second way to invest in dividend stocks. In doing so we will move from the area of active management to passive management. The goal of ETFs is not to beat the index, just to match it. And to accomplish that all they need to do is purchase a basket of stocks that faithfully mirrors the index. Since indexes rarely change, not much trading is required, thus expenses are much lower and tax bites are reduced significantly.

ETFs are becoming very popular in Canada where they originated. Since their introduction in the early '90s, sales have grown by almost 30 percent in the past five years, compared with 5.6 percent for mutual funds, mainly because of lower fees. With this growth has come a wider range of products and now ETFs can be found for just about every asset class and sector of the market as well as many geographical areas. The ET in ETF stands for exchange traded, which means that they are bought and sold through a brokerage account. This adds to the cost, but it is a one-time charge and with online brokers charging as little as $10 per trade this expense is small compared to annual mutual fund MERs, especially if you are a long-term investor.

In contrast to the plethora of mutual funds, there are only six ETF firms in Canada, each with up to a dozen or so funds. Currently there are just three ETFs that concentrate on Canadian dividend-paying stocks (one contains about 30% income trusts and the rest common stocks, the other two are solely stocks; one offers a DRIP [Dividend Reinvestment Plan] plan). How have they performed? They have done quite well (Table 2), but keep in mind that they are few in number and have only been around a short time.

Table 2. Average returns of Canadian dividend ETFs.[1]

	MER[2]	1 year	3 years	5 years	10 years
Avg ETF	0.55%	14.9%	-3.4%	–	–
TSX TR[3]		12.0%	-3.9%		

[1]As of June 30, 2010. Average annual compound returns, with reinvestment of distributions. Data source: globefund.com
[2]Management Expense Ratio
[3]S&P/TSX Total Return

Exchange-traded funds offer some real advantages over mutual funds to individual investors, particularly those interested in dividend investing, since they combine lower cost with diversification and ease of ownership. It is important to remember, though, that these products are designed to mimic an index, and, as we all know, indexes can and do go down as well as up. In the third and last column in this series I will discuss dividend investing through the ownership of individual common stocks.

For both mutual funds and exchange-traded funds, you will find updated return information regularly published in *Canadian MoneySaver* and on this site.

I hope you find this information useful and if you have questions please pass them along to Dale Ennis at the *Canadian MoneySaver* who will forward them to me.

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