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Income and downside protection

DIVIDEND STREAM

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THE SALE OF DIVIDEND AND income funds in Canada has risen by almost 60% so far in 2005, according to the Investment Funds Institute of Canada, meeting a demand for a mix of security and yield.

The rush to buy dividend funds is less of a fad than one might think. While some may argue that the swing to conservative investing is a response to the billions lost when the technology bubble burst, longer-term history gives us a different explanation.

The period in the mid to late

'90s was an anomaly. It was a period when growth stocks prevailed and more than three quarters of the return in the stock market came from the higher multiples investors put on company earnings.

The correction in the market in the early part of the 21st century, when technology and high price-earnings multiple stocks collapsed, is a reminder that superior returns in the stock market have come from stocks that pay dividends and reinvesting those dividends. If you look at North American stock market returns over the long run, according to research from CIBC World Markets, more than 60% of the total return in Canadian stocks in the past 50 years has been generated by the dividend yield and the reinvestment of dividends.

The paradox is that the divi-

dend yield on the stock market is near its lowest level in 100 years. Currently, dividend yield on the S&P/TSX Composite Index is 1.7%. The difficulty for dividend funds today is not only that the yield on the market is low but also that the universe of high-yielding stocks is getting smaller.

In Canada this phenomenon has fuelled the acceptance and growth of the income trust market. With low bond yields and a shrinking and illiquid preferred share market, it is no wonder that the income trust market is thriving and that dividend funds are snapping them up.

As manager of numerous equity value and income funds, I believe that one of the ways to build wealth for a client is to concentrate on high-yielding stocks and income trusts. As a conservative wealth-building investor, dividends are important to me. They are an indication of how well a company is run and typically a signal of its financial health, and a way of allowing investors to share in the ongoing profitability of the company.

The steady returns from dividends also provide downside protection in weak markets. This is a feature that can't be taken seriously enough in today's volatile investing climate.

According to research by the value team at TAL Global Asset Management, the bottom line is



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that stocks with stable and or growing dividends have outperformed over the past 10 years and have offered lower volatility. For the income generation portfolio that the TAL team manages for CIBC's Personal Portfolio Services, we invest only in equities that have had a proven track record in paying dividends. For that portfolio, we have isolated stocks in the Canadian equity universe that have a five-year record of stable and growing dividends.

While the list in Canada is not large, there is still enough to choose from. Virtually all of the Canadian banks make the cut, as do many other financial services stocks. In contrast, there are fewer suitable names in the materials and industrial sectors, where earnings tend to be cyclical, making dividends unpredictable.

A good example of a stock with a record of growing its dividends over time is **Linamar Corp.** In its value portfolios TAL owns both Canadian auto parts companies — **Magna International Inc.** and Linamar Corp. Guelph, Ontario-based Linamar is the one that has had the required five-year track record in dividend growth required for inclusion in our income generation screen.

Linamar designs, develops, and manufactures precision-machined components, modules, and systems for engines, transmissions, and chassis systems for the North American and European marketplace. With a stellar record of earnings, a solid balance sheet and a normalized return on equity of 12%, this well-run company is experiencing strong performance as it benefits from the trend in outsourcing that is taking place

among North American automobile manufacturers. Linamar's current dividend yield is modest at 1.4%, but its consistency is what is depended on.

Another favorite is **Manitoba Telecom Services Inc.**, the leading telecommunications company in Manitoba. Manitoba Telecom provides local, long distance, and cellular telephone service with 1.2 million access lines and nearly 300,000 cellular customers.

Over the years Manitoba Tel has demonstrated its leadership in the telecommunications field. It was the first in Canada to recognize the changing landscape where Internet protocol would allow cable and telecommunications companies to vie for residential video, voice, and high-speed Internet.

As early as 2000, it began to expand its broadband capabilities. Today, Manitoba Tel has broadband capabilities extending to 85% of the households in Manitoba, and the competition is furiously trying to catch up.

In 2003, Manitoba Telecom purchased Allstream Inc., making it the third largest telco in Canada. With a clean, stable balance sheet, and strong and growing cash flow, Manitoba Telecom has also demonstrated its financial leadership.

Its current 5.4% yield is one of the highest on the TSX, and it has a stable history of dividend growth over many years.

Rothmans Inc. is another name that shows up on both the TAL value and income generation screens. Canada's only publicly traded tobacco company, Rothmans has 50% market share of the high-end cigarette market and

40% of the lower-margin, rapidly growing discount market.

Although Rothmans is always on the hunt for good acquisitions, its attempts have been stymied in the recent past as larger, multinational firms outbid it. The company is a strong cash generator, with a normalized 47% return on equity and a current dividend yield of 5%.

Rothman's has also announced special dividends in the past, including a \$1.50 special dividend this past March. While earnings are expected to continue to grow modestly, dividends could grow by 10% a year.

There are instances, though, when a high dividend yield could signal not a high-quality investment but instead a problem with the company. A close examination of the cash flow statement and the balance sheet should help determine the financial strength of the company.

The one caveat on high-yielding vehicles of all types, including high dividend paying stocks, is that they tend to be interest-rate sensitive. When interest rates go up, these stocks come under some price pressure. Typically, rising interest rates indicate a strong economy, which helps economically sensitive, or cyclical, stocks. Balancing high-yielding, dividend-paying stocks with economically sensitive, cyclical investments can enhance your return and reduce your risk. ▼

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