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Dividend equity gains popularity

Analyst finds cyclical non-resource stocks offer value

According to Credit Suisse, inflows into dividend ETF products in the U.S. increased from \$2.5 billion in 2009 to nearly \$17 billion in 2011 and year-to-date are nearly \$11.4 billion of net new assets. The number of dividend-centric ETFs has doubled, from 24 in 2007 to 50 at present, with 14 launched since 2011.

This dramatic increase in popularity of high dividend equity products has raised questions of a dividend bubble, and many investors wonder if the trend can continue or whether it is now over-inflated and due for a correction.

Credit Suisse doesn't believe a bubble has formed and they point to economic price earnings multiples as a gauge of overall valuations. Their research shows stocks with a dividend yield higher than the S&P 500 are trading at an Economic P/E multiple of 16.9 times earnings, representing a 0.4x multiple discount to the market. Although these high dividend yield companies have historically traded at a higher discount to market, Credit Suisse sees evidence of the valuation discount disappearing and considers the post credit crisis era a more plausible benchmark for the valuation of high dividend yield stocks going forward.

Canaccord Genuity analyst Martin Roberge agrees that the yield trade remains intact and believes it is largely due to a new class of "income" buyers: baby boomers and pension funds. According to

Roberge, the portion of baby boomers in the Canadian population will increase from 21% today to just over 39% in the next 15 years. Ageing baby boomers will increasingly seek low volatility investments, primarily in the form of balanced funds whose equity components are largely comprised of dividend-producing investments.

Roberge points to underfunded pensions as another group that will help support the prices of dividend paying stocks. Using a conservative asset mix, Roberge believes defined-benefit pension plans are approximately 65% underfunded as of the end of April. Maturing pension funds are yet another consideration because they face the predicament of retirees exceeding the number of pension contributors. To make up for cash flow shortfalls, pension fund managers are likely to favor the regular and timely payments of dividend investments.

Not all high yield dividend yield stocks are inexpensive, and Credit Suisse feels that investors need to be selective. Three of the four most expensive sectors on Economic P/E are also the highest yield sectors: Consumer Staples (20x), Utilities (28x), and Telecom (21x). According to their analysis, the valuations of dividend paying stocks with an above average payout ratio are starting to look stretched and they prefer those that pay out a smaller portion of their earnings. The median Economic P/E for dividend paying companies with a low dividend payout ratio is

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15.1x, which represents a 2.1x discount to market. Credit Suisse believes the potential for this group to grow dividends and increase their payout ratio could offer an attractive way to invest in the dividend theme.

Roberge agrees that more discrimination is warranted, and examined the three types of dividend yielders in the S&P/TSX— cyclical resources (energy, materials), cyclical non-resources (financials, industrials, consumers), and defensives (telecoms, utilities, pipeline, REITs) –

to determine growth potential. Roberge found that cyclical non-resource stocks offer the most value and cautioned that resource yielders could be considered “value traps”. Although they provide the highest dividend yield, they also come with greater potential for volatility.

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