INVESTMENT EXECUTIVE
CANADA'S NEWSPAPER FOR FINANCIAL ADVISORS

Boosting client income

Investors need to know that stocks with big dividend yields are not less volatile than stocks in general

February 2011 Print Edition

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With low interest rates dampening returns from bonds, many financial advisors are using stocks and mutual funds with high dividend yields to bolster income returns for their clients.

Based on an analysis of high-dividend-yield stock returns conducted by my firm, Tacita Capital Inc., this can be a wise move for the right clients.

However, caveats are in order.

HDY stocks have outperformed the overall market globally, as well as in the U.S. The annualized return in U.S. dollars of the MSCI world high dividend yield index, from July 1995 through December 2010, was 9% — besting the 6.5% return of the MSCI world index. In the U.S., the Dow Jones U.S. select dividend index had a 10.2% return, easily outdistancing the 7.5% return of the S&P 500.

This experience is consistent with the findings of longer-term research on U.S. stocks conducted by Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School. They found that from 1926 through 2000, HDY stocks had an annualized average return of 12.2% and outperformed the overall market's 10.6% return by 1.6% a year.

However, your clients need to be aware that HDY stocks don't always outperform. In Canada, the S&P TSX composite index had an annualized return of 6.5%, ahead of the 4.6% return of the Dow Jones

Canada select dividend index, from 2006 through 2010.

During a commodities boom, many investors prefer to position their portfolios for growth in the materials sector. Given the propensity of many investors to lose patience with even sound strategies such as HDY stocks, some modest exposure to the broader Canadian market is in order.

Your clients also need to know that HDY stocks are not materially less volatile than stocks in general.

In Canada, for example, the Dow Jones Canada select dividend index had an annualized standard deviation of 16.9 vs. the market's 18.2.

In the U.S. and globally, HDY stocks were actually slightly more volatile than the overall market.

And regardless of income objectives, HDY stocks are never a replacement for bonds if your client cannot tolerate volatility. Contrast the above 16.9 standard deviation for the Dow Jones Canada select dividend index with the DEX universe bond index's 3.7 standard deviation over the same period.

Finally, HDY stocks are not particularly tax-effective. If a client is simply reinvesting the dividends within a non-registered account, you and your client might consider alternative strategies.

At its core, a high-dividend strategy is a value strategy. Dividend yield is calculated using the annual dividend divided by the share price, so a high dividend yield is typically driven by a price that is low in relation to the dividend.

In fact, the correlation between the returns of the MSCI world HDY index and those of the MSCI world value index is 0.964.

Alternative value strategies, such as buying stocks with low price/book or low price/earnings ratios, also have superior return potential. And often with less tax drag. **IE**

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