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Looking for income?

Utility stocks just might fit the bill

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With interest rates at levels not seen since the Second World War and stock prices in the red, many financial advisors are assessing ways to improve the income and risk-adjusted return potential of their clients' portfolios.

One candidate is utility stocks. To obtain a longer-term picture of this sector's performance, researchers at my firm, Tacita Capital Inc. of Toronto, spliced the discontinued TSX utilities index with the S&P/TSX utility index and analyzed their joint performance from February 1980 to August 2011.

During this period, Canadian utility stocks outperformed Canadian bonds and stocks, as well as foreign stocks. Utilities' annualized return of 11.6% bested the 9.9% and 9% returns of the DEX universe bond and S&P/TSX composite indices, respectively, as well as outpaced the 10.3% and 9% respective returns of the S&P 500 and the MSCI EAFE indices.

This higher return was achieved with lower volatility. Canadian utility stocks had an annualized standard deviation of 15.3%, below the 17.8% average of Canadian stocks and the 15.8% and 17.6% respective standard deviations of U.S. and international stocks. Canadian utilities were also slightly less volatile than their U.S. counterparts; U.S. utilities had an annualized standard deviation of 16.5%. Overall, Canadian utility stocks had the best risk-adjusted returns.

Canadian utility stocks had a low beta exposure of only 0.37 over the period studied. The distinctive nature of utilities — capital-intensive, long-life assets; stability in demand; long-term financial leverage; and a regulatory environment that primarily sets rates based the cost of equity capital — creates a risk profile that is only partially explained by stock market exposure.

But beyond the idiosyncratic sector risk, such as environmental regulation, utility stocks have significant exposure to interest rate risk. Canadian utility stock returns were closely correlated to those of the S&P/TSX composite and the DEX long-term bond indices, with a correlation of 0.43. And utilities had a very modest negative correlation of minus 0.02 with Canadian long-term government bond yields. Advisors who believe long-term bond rates will be low for the foreseeable future should take special note of utility stocks.

Utility stocks are not a panacea for buffering portfolio declines. Based on month end values, Canadian utility stocks suffered a maximum drawdown of 39.2% from May 1998 to February 2000. This was a period in which the stock market initially declined, followed by long-term bond rate increases, creating a double whammy for utility stocks. Utility stocks did, however, have three fewer drawdowns of greater than 10% than the TSX over the 31.5 year period — six vs. nine. Utility stocks also declined by less in the global credit crisis, with a minus 31.6% return vs. the market's overall loss of 43.4%.

Canadian utility stocks currently have a dividend yield of approximately 4.7%, making them attractive to income-oriented investors. When making allocations to this sector, however, be mindful of the risk of rising interest rates in the future.

In addition, valuations are currently elevated. The utility sector is trading at trailing price/earnings ratio of 20.1, a 10% premium to its 10-year average. **IE**

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