INVESTMENT STRATEGY RESEARCH

RBC Capital Markets

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In search of safe income

Finding consistent dividend growth and high yield

All values in Canadian dollars unless otherwise noted.

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Key points

- **Our view:** The dramatic move lower in interest rates over the last decade has completely altered the income landscape. Against this backdrop, our screens suggest that **the S&P/TSX offers an oversized dose of what we term "safe income" relative to the S&P 500.**

- Ten years ago, the U.S. 10-year yielded more than 5%, the average European sovereign yielded more than 4%, and Government of Canada's yielded nearly 4.5%. Meanwhile, stocks on average yielded nearly 2% less than what could be earned on "safe" government bonds.

- Fast forward a decade and the relationship of bond yields and stock dividend yields has been completely turned on its ear. While we are not prepared to say that a dramatic shift in behaviour is imminent, we do believe that increasingly in the years to come, **stocks that accomplish the combination of consistent dividend growth and high yield will increasingly be in demand** as the challenges of an aging population and liability matching become increasingly acute.

We ran a screen that helps to identify North American stocks that have consistently raised their dividends over time, have a high current dividend yield, and are large cap. **Spoiler alert: The list is not long and is dominated by Canadian banks.**

In search of safe income

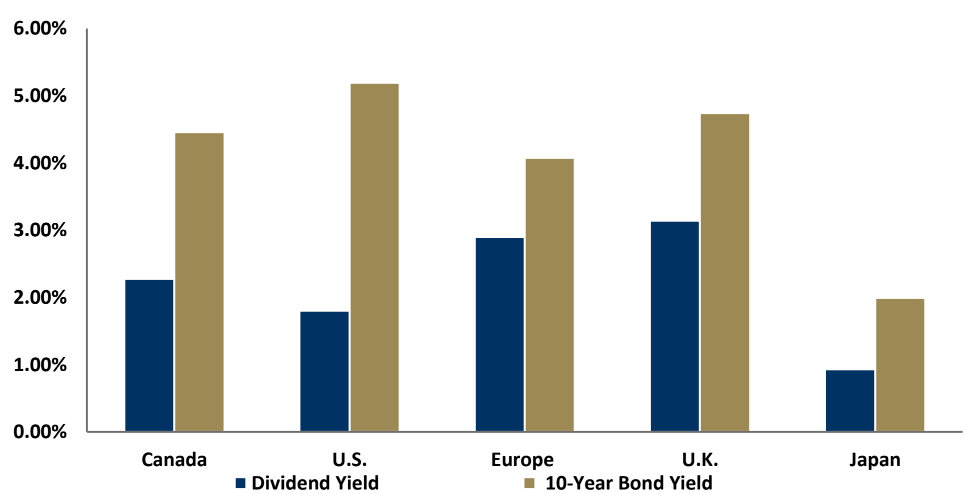
Key points

- Ten years ago bond yields in most developed countries were about twice that of the average stock.
- A decade later, the relationship has been completely flipped, with the average stock in most major indices now yielding significantly more than sovereign bonds.
- As the landscape continues to shift, we believe the need for "safe income" will become increasingly acute, with the stock market becoming a larger source of income for those seeking some sort of liability matching solution.
- We present a screen based on several factors designed to identify "safe income" in North American equity markets. We present a list of 14 names (7 Canadian and 7 U.S.) that make it through our filters.

The changing nature of income

If we go back just a decade, the investment landscape looked completely different. While the global population was aging and the first phase of baby boomers had just begun to enter their retirement years, government bonds in the U.S., Canada, and Europe offered reasonable yields that promised to help satisfy the growing need for safe income. To be sure, government bond yields were lower than they had been a decade before, but they still offered significantly more yield than the average stock and thus were a core part of most income mandates.

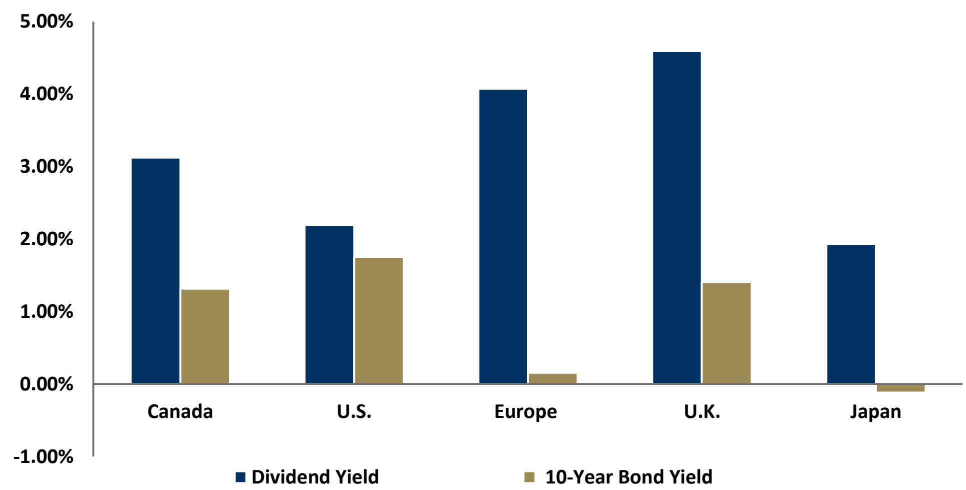
Exhibit 1: Ten years ago, government bonds yielded significantly more than stocks



Source: Bloomberg, RBC CM Canadian Equity Strategy

Fast forward a decade and the landscape has been nearly completely flipped. The global population has continued to age and the search for income has intensified, but government bond yields have collapsed. The lone stalwart in all of this has been stocks, which despite reasonable gains point to point (it's been a roller coaster to be sure) actually provide higher yields on average than they did a decade ago.

Exhibit 2: Today, stocks in most countries yield at least twice as much as bonds

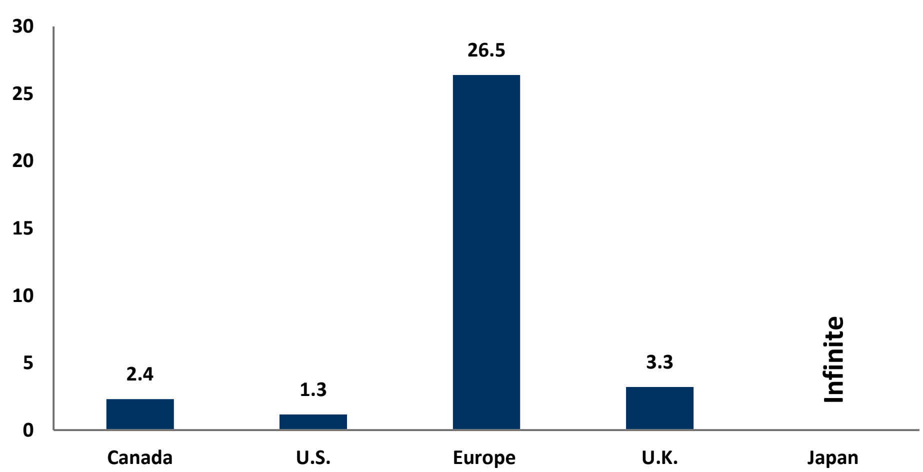


Source: Bloomberg, RBC CM Canadian Equity Strategy

To put things in perspective, it would now take more than two years for a government of Canada bond to match the income on the average stock, more than three years in the U.K., and more than a quarter-century on a euro bond.

Exhibit 3: As bond yields have plummeted, the time to "payback" has grown

Time for bond income to match average stock income (in years)



Source: Bloomberg, RBC CM Canadian Equity Strategy

The safe income screen

We begin with the assumption that some investors are unlikely to view equity-based income as entirely safe, as they could cite the likes of WaMu, General Electric (GE), or other companies that had “never” cut their dividends until they did (and in the case of WaMu, until it disappeared entirely). That said, our definition of “safe income” would be income that comes from the equity market in which there is limited risk to that income stream facing disruption.

To get to a list of safe income stocks, we thought about what attributes investors might look for in finding reliable income. In addition, we thought that “ease of use” would be important and thus we opted to focus on large cap stocks that would be easy to buy and sell. Furthermore, we wanted some bang for our buck, as ten years ago one could get upwards of 4% or more from most government bonds globally and we sought to replicate that reality as opposed to settling for lower yield.

Armed with this, we ran a variety of screens until we settled on the following (we also provide our rationale for choosing these):

- **Market capitalization greater than CDN$20 billion:** As we mentioned earlier, we wanted to focus on large cap names that were liquid.
- **Dividend yield of 3.75% or more:** We chose a threshold that was roughly commensurate with what one could have gotten on 10-year government bonds ten years ago.
- **Compounded 5-year dividend growth of at least 3%:** We thought 3% was a fair threshold for a low-growth environment.
- **Dividend history of at least 10 years:** It would have perhaps been sexy to include some technology companies that have recently gotten dividend religion, but: 1) that made us nervous; and 2) we do think a long track record matters.
- **Has not cut its dividend in the last 10 years:** Our thinking was that if you survived the worst economic recession since the Great Depression without cutting your dividend, you have a good chance of surviving whatever is to come in the next 10 years.
- **Has raised its dividend for at least eight of last 10 years:** It is hard not to give some free passes for the Financial Crisis, but we wanted consistency of dividend growth, as high yield + consistent growth of dividend is a nice combination in a world where income is so hard to find.
- **Not a direct play on commodity prices:** We were cautious on any company directly dependent on commodity prices to maintain and grow its dividend.

The results

We started with a universe of more than 700 names, and after running through the above, we ended up with 14 names: 7 Canadian and 7 U.S., which provides a nice bit of symmetry. Collectively, our group trades with a median yield of 4.4% and median trailing 5-year dividend growth of nearly 8%. The median size is CDN$51 billion, while the median trailing price-to-earnings multiple is 16.6x.

The "safe income" screen

Company Name	Home Market	Subsector	Last Price	Market Cap	Dividend Yield	5-Year Trailing Div. Growth	Trailing PE
Bank of Nova Scotia	Canada	Banks	$62.62	$76 BN	4.6%	6.8%	10.7x
Canadian Imperial Bank of Commerce	Canada	Banks	$101.14	$40 BN	4.7%	4.4%	10.7x
Toronto-Dominion Bank	Canada	Banks	$56.09	$104 BN	3.9%	10.6%	12.2x
Ventas Inc	U.S.	REITs	US$66.76	US$22 BN	4.4%	7.2%	44.0x
Welltower Inc	U.S.	REITs	US$71.77	US$26 BN	4.8%	3.8%	31.3x
The Southern Company	U.S.	Utility	US$49.89	US$46 BN	4.5%	3.6%	17.2x
Rogers Communications	Canada	Telecom	$49.25	$26 BN	3.9%	8.4%	18.0x
TELUS Corporation	Canada	Telecom	$40.53	$24 BN	4.5%	11.0%	16.0x
Verizon Communications	U.S.	Telecom	US$50.94	US$210 BN	4.4%	3.2%	12.7x
Caterpillar Inc	U.S.	Industrials	US$70.07	US$42 BN	4.3%	11.3%	21.3x
International Business Machines	U.S.	Technology	US$147.72	US$143 BN	3.8%	15.0%	9.9x
Qualcomm Incorporated	U.S.	Technology	US$51.32	US$76 BN	4.1%	20.2%	15.6x
Enbridge Inc.	Canada	Pipelines	$51.70	$48 BN	4.1%	16.9%	23.7x
TransCanada Corporation	Canada	Pipelines	$51.75	$41 BN	4.4%	5.4%	20.6x
Median				***$51 BN***	***4.4%***	***7.8%***	***16.6x***

All prices are in Canadian dollars unless otherwise noted
Source: CPMS, Bloomberg, RBC CM Canadian Equity Strategy

Some things we would note about the results of the screen:

- The market cap of the S&P/TSX is less than 15% that of the S&P 500, yet the TSX provided half of the names after all was said and done.
- Canadian banks made up 21% of the final results. While we understand there may be some pent-up scepticism toward the Canadian banks, we note that none of the Big 5 Canadian banks has cut its dividends in more than seven decades, which included some fairly poor economic backdrops.
- The screen was heavy on interest-sensitive stocks. However, we believe that the above would fare far better in a rising rate environment than would a portfolio of government bonds.
- The list was bereft of any Consumer Staples, which have become defensive safe havens for many investors in Canada and the U.S. Our yield threshold ultimately eliminated most of these names from consideration.
- $1 million equally invested in the 14 names above and assuming 2% annual dividend growth going forward would generate income of about $467,000 over the next decade. In contrast, a government bond in the U.S. or Canada would generate anywhere from $130,000 to $180,000 over the same period. For our "basket" of names to generate a lower return under these assumptions, they would have to collectively decline between 30% and 34% over the next 10 years, which is a considerable buffer in our view.

Conclusion

The collapse in global bond yields over the last decade has completely shifted the investment landscape. Utilizing the tools of the past for strategies such as liability matching or the traditional 60/40 portfolio is unlikely to come close to achieving targeted long-term returns. We believe that against this backdrop investors will have to continually turn to the equity market for at least part of the solution.

Our screen, which we grant is strict in its rule set, provides at least a starting part for identifying high-yielding businesses that have a prolonged track record of not only paying dividends but also growing them consistently over time. All managed to “survive” the Great Recession without cutting their dividends and, in fact, quickly re-started their dividend growth strategies when the dust settled.

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