HARNESSING THE POWER OF DIVIDENDS

Income, Growth & Diversification

The last few years have seen a number of factors driving the popularity of dividend-paying equities. As more and more income-seeking baby boomers retire, demographics increasingly support a need for dividend-paying investments. Record low interest rates and an abundance of defensively positioned portfolios have also supported dividend investing since the financial crisis of 2008/2009.

However, over the years, dividend payers have offered a lot more than an income boost or a "safe" way to buy stocks. They have provided the majority of long-term market returns and contributed to lower portfolio risk. They have also provided tax-efficient growing income and the opportunity to build an effectively diversified portfolio.

Here we look at the power of a dividend-focused investment strategy, including:

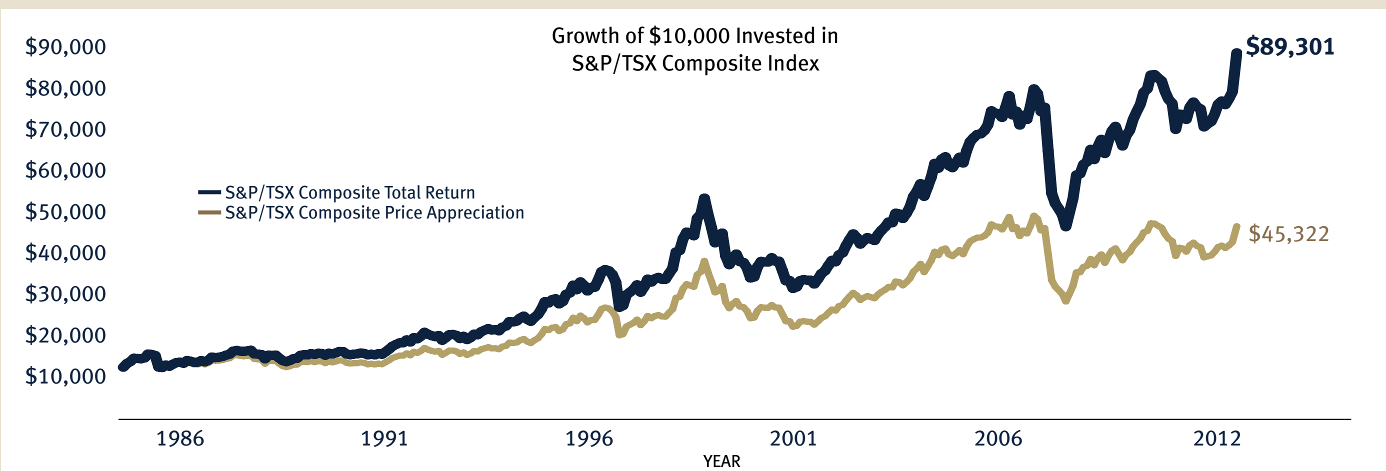
- The performance of dividend equities relative to the overall market.
- The effectiveness of dividends as an income strategy.
- How to combine attractive dividend yields with the potential for dividend growth.

Dividends and the market

A key role in portfolios: Dividend-paying companies represent a significant portion of the global equity market. For example, over 80% of S&P 500 Index companies and close to 80% of S&P/TSX Composite Index companies pay a dividend. Among these are a broad range of well-established, stable and soundly managed businesses from which to build a diversified portfolio. Dividend payments can provide a steady cash flow stream that can be reinvested, reallocated or used for income. When markets decline, they can help offset losses. And when markets rise, they can help boost portfolio returns.

An important component of long-term returns: In Canada, dividend payments comprised over 30% of total equity market returns between 1986 and 2013. As shown in the chart above, investors who reinvested dividends over this period saw total returns that were nearly twice the size of the market's price returns.

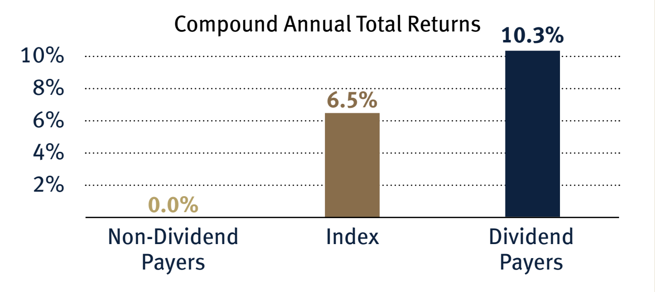
Dividends Have Consistently Contributed to Total Returns, Year After Year



Source: RBC Global Asset Management – December 1986 to December 2013.

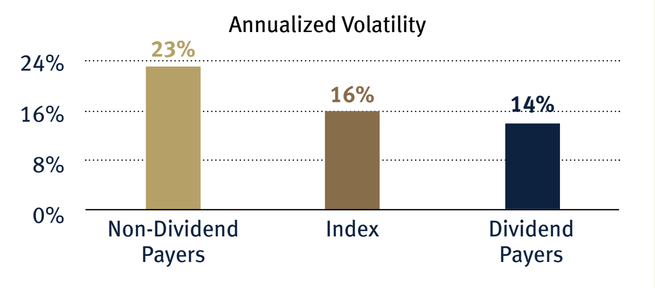
Market leadership and attractive risk-adjusted returns: Conventional thinking states that taking on higher risk is the only way to potentially achieve higher returns. However, as the charts below illustrate, companies that pay dividends have not only historically outperformed the index by a wide margin, but have done so with significantly lower volatility.

Dividend-Paying Stocks Have Outperformed Over Time



Source: RBC Capital Markets Quantitative Research, data is calculated on an equal weight basis, S&P/TSX Composite Total Return Index, December 1986 – December 2013.

Dividend-Paying Stocks Have Displayed Lower Volatility Over Time



Source: RBC Capital Markets Quantitative Research, annualized volatility is calculated on an equal weighted basis, S&P/TSX Composite Total Return Index, December 1986 – December 2013.

A powerful income strategy

Income growth that's well ahead of inflation: Along with superior risk-adjusted returns, dividends themselves have provided investors with excellent inflation protection. Over the past 25 years, the S&P/TSX Composite Index dividend yield has grown at just over 5% annually, whereas inflation has driven price increases of just over 2% annually (see table below). Compounded over that time period, inflation caused prices to increase by 70%, while dividend income grew by 244%. The bottom line: investors who continuously withdrew their dividends throughout the past 25 years were rewarded with a remarkable increase in their income relative to inflation.

Index Dividend Yield Growth

	Base March 31, 1989	March 31, 2014	Annualized Growth Rate
S&P/TSX Composite Index Dividend	$100	$344	5.1%
Canadian Consumer Price Index	$100	$170	2.1%

Source: RBC GAM, Bank of Canada. Index dividend was calculated using the following method: Index dividend = Index Total Return – Index Price Return.

Superior tax efficiency: It's no secret that eligible dividends are one of the lowest taxed sources of investment income in Canada. From the lowest to the highest tax bracket, eligible dividends are taxed significantly less than interest and regular income.

Assuming the top combined federal and Ontario tax rates, a 4% bond yield is roughly equivalent to a 3% dividend yield on an after-tax basis. Today, however, Canadian investment grade bond yields are in the 3% range, while a dividend-focused strategy can comfortably achieve a quality yield in the 4% range. As such, a dividend strategy today can provide a more attractive income stream for investors on a pre-tax basis, and by an even greater margin on an after-tax basis (see table below).

Income Stream for Investors

	2014 Combined Top Federal & Provincial Marginal Tax Rates		Earn More and Keep More With Dividends Today's Typical After-Tax Yields	
Province	Interest Income	Eligible Dividend Income	3% Bond Interest	4% Eligible Dividend Income
Alberta	39.00%	17.72%	1.83%	3.29%
British Columbia	43.70%	23.91%	1.69%	3.04%
Manitoba	46.40%	26.74%	1.61%	2.93%
New Brunswick	43.30%	20.96%	1.70%	3.16%
Newfoundland & Labrador	42.30%	20.96%	1.73%	3.16%
Northwest Territories	43.05%	22.33%	1.71%	3.11%
Nova Scotia	50.00%	34.85%	1.50%	2.61%
Nunavut	40.50%	25.73%	1.79%	2.97%
Ontario	46.41%	28.19%	1.61%	2.87%
Prince Edward Island	47.37%	27.33%	1.58%	2.91%
Quebec	48.22%	24.11%	1.55%	3.04%
Saskatchewan	44.00%	23.36%	1.68%	3.07%
Yukon Territories	42.40%	14.28%	1.73%	3.43%

Source: taxtips.ca

Chasing yield and looking to the past

Historically, the focus of dividend ETF investing has been dominated by two strategies. The first dividend ETF strategy is to invest in companies with high dividend yields in the hopes of providing outsized income and the long-term benefits of dividend-payer outperformance. However, many investors have learned that high yields are often red flags for value traps, low-to-no earnings growth or, even worse, future dividend cuts.

The second dividend ETF strategy is to focus solely on historical dividend growers with the assumption that the trends of dividend growth and capital gains will continue. One significant downside to this strategy can be a sacrifice of the attractive dividend of a yield-oriented strategy. A focus on historical long-term dividend growers might also ignore companies that have a smaller capitalization; are newer, yet still fundamentally attractive; are currently transforming their strategy into a dividend-paying model; or are turning the corner on their ability to pay and grow their dividend. Further, research by RBC Global Asset Management's Quantitative Investment Management team has shown that historical dividend growth alone has not been a reliable indicator that a business is healthy or will continue to grow its dividend.

With these two dividend ETF strategies, investors are forced to make a mutually exclusive decision to either chase high yields or purchase dividend growth stocks. But, ultimately, neither strategy provides the full breadth of benefits from dividend investing.

Follow the leaders

Payment decisions for company dividends are generally made by the board of directors on a quarterly basis. When a board declares a dividend, it has to review whether or not the company can safely pay and/or grow the dividend. Key fundamental factors that the board reviews include whether paying a dividend will allow the company to maintain balance sheet strength and flexibility; future expectations for free cash flow; required capital for future investments and expenditures; and expected profitability of those investments, continuing operations and new lines of business.

As an equity investor, why not also review these forward-looking factors? After all, a company's future health and profitability are more likely to drive stable and growing dividends than a historical dividend-paying track record.

RBC Quant Dividend Leaders ETFs: The best of both worlds

In order to build a portfolio that provides attractive income, RBC Quant Dividend Leaders ETFs ("RBC ETFs") first filter their investment universe for attractive dividend yields. Second, they filter for many of the same forward-looking factors used by company boards to help ensure a portfolio of companies that can provide stable dividends and potential dividend growth. To prevent some of the risks of relying entirely on company financial statements, the RBC ETFs may also use market sentiment factors like short interest to gauge whether other market participants deem the companies healthy. Finally, unlike many other dividend strategies, the investment universe considered includes small-, mid- and large-cap names, leaving no "income opportunity stone unturned" to provide broad diversification by both sector and cap size.

Today's investors want it all – an attractive monthly income stream that has the ability to grow over time, and long-term capital growth from a diversified portfolio of sound, stable dividend-paying companies. RBC ETFs offer a strategic, well-thought-out solution that uses forward-looking variables to provide these characteristics. Instead of forcing investors to choose one objective or the other, RBC ETFs offer the best of both worlds: the growth potential of a dividend growers portfolio, combined with the attractive income of a high-dividend portfolio. And they do so by answering the key questions that dividend investors are always asking:

Is the dividend safe and is it likely to grow? Where are the best dividend-paying opportunities?

RBC Quant Dividend Leaders ETFs is designed to solve for these questions and take the weight off of the shoulders of investors looking for attractive income, growth potential and diversification from their dividend portfolios.

RBC Global
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