The case for income investing

The current low-interest-rate environment has caused many investors to look beyond traditional fixed-income instruments, necessitating a disciplined approach to selecting equities within an income-producing portfolio. In addition, for a broader range of investors, there are several reasons why dividend-paying stocks might play an integral role in every portfolio.

Yield replacement: A replacement for lower-yielding fixed-income instruments for investors willing to accept the risks related to owning an equity investment.

Diversification: Equity and fixed-income instruments do not always move in the same direction. As such, investors stand to reap the benefits of diversification through lower correlation and volatility.

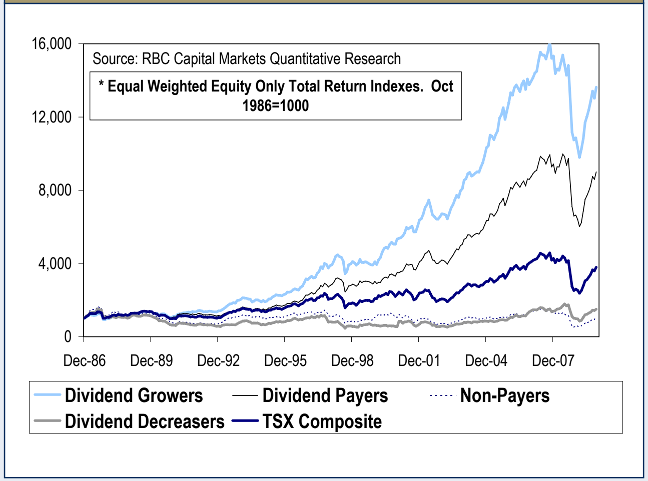
Potential for capital appreciation: Investors have the opportunity to participate in the longer-term capital appreciation potential of the equity market, although accepting potentially greater volatility over shorter horizons.

Inflation hedge: While rising inflation and interest rates will reduce the value of most income-oriented assets, owning dividend-paying stocks that have an ability to grow revenues and profits in such an environment may help sustain higher portfolio valuations.

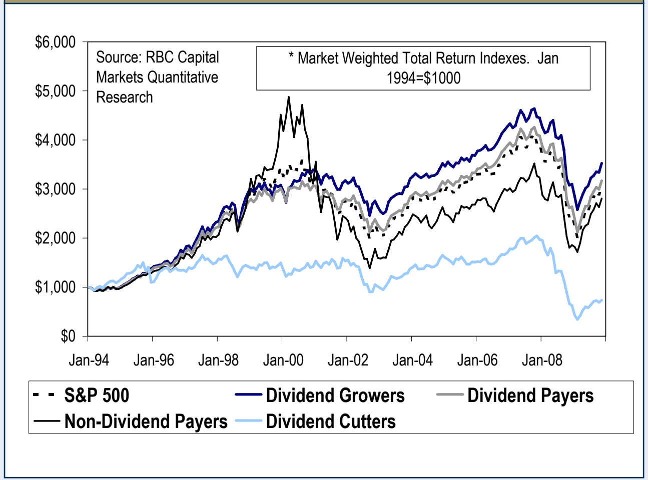
Tax benefit: Dividends paid from eligible Canadian corporations are taxed at a lower rate compared to interest received from bonds.

Superior returns potential over time: Although lower-quality, non-dividend-paying stocks dominated the recent dramatic market rally, over longer time horizons, dividend-paying stocks have tended to outperform non-dividend payers. Upon closer inspection, amongst the dividend-paying stocks, those that grow their dividends have performed the best, while companies that cut their dividends have significantly underperformed. One likely explanation is that a proven ability to pay and grow dividends through thick and thin is often indicative of a company with a better-than-average business model and an above-average management team able to balance the trade-off between ensuring long-term earnings growth and meeting shareholder demands for income.

Canadian Dividend Study



U.S. Dividend Study



Equity income portfolio

The objective of the Equity Income Guided Portfolio is to provide participants with an above-average, consistent cash-flow stream by investing in a diversified portfolio of higher-yielding Canadian securities such as common stocks, Real Estate Investment Trusts (REITs), income trusts and similar investments. It is actively managed on a quarterly basis to enhance income and long-term returns while managing the risks inherent in a higher income-yielding strategy.

Step 1

The "top-down" (macro-level) strategy process employed by the RBC Investment Strategy Committee plays a different role in the Equity Income Guided Portfolio process than with our other Guided Portfolios. While the recommended sector over-weights and under-weights are taken into consideration, the Committee aims to adequately diversify the portfolio across the four broader sector buckets (Interest Sensitive, Consumer, Industrial, and Resources) even if the dividend is more modest. In this way, we address one of the most common pitfalls inherent in income investing, that being that investors who focus too narrowly on the size of the dividend will more than likely find themselves heavily concentrated in the financial and utility sectors, which tend to react negatively to rising interest rates.

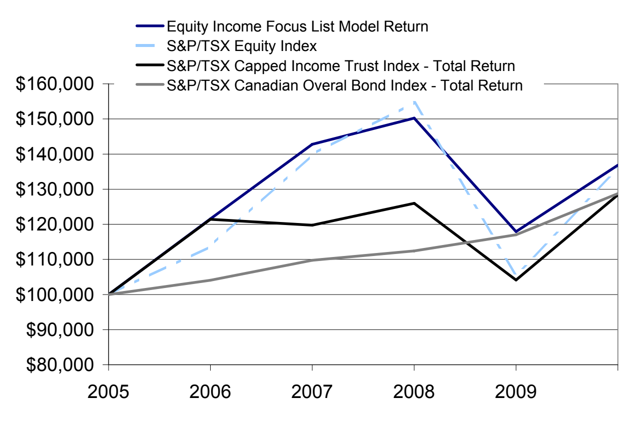
Step 2

Once the sector weights are established, an eligible universe of securities is determined. Careful consideration is given to identifying a pool of fundamentally preferred companies that return, or have the potential to return, on a sustainable basis, a significant amount of its cash flow to investors. The resulting universe will consist of securities that have either an attractive dividend yield, or a yield that may appear less attractive, but which we believe has strong potential for growth. In addition, companies that pay out too high a percentage of their cash flows in dividends or distributions will be excluded.

Step 3

The portfolio consists of 20 securities. To populate the positions across each sector bucket, the Committee looks to the eligible universe of securities established in Step 2 and applies a number of criteria to determine a security's relative attractiveness. In some ways, a high yield can be a poor criterion for choosing an investment and that is why we focus on several criteria to identify dividend growers. Some of these factors include a company's financial strength and debt levels, the amount of cash flows generated by the business relative to capital expenditure requirements, its longer-term return on capital, the proportion of income that is paid out versus reinvested, historical and forecasted dividend growth rates, and trading liquidity.

Equity Income Focus List Performance



Equity Income Guided Portfolio	Price	Yield
Intact Financial (IFC)	$35.93	3.6%
Royal Bank (RY)	$54.91	3.6%
IGM Financial(IGM)	$43.27	4.7%
National Bank (NA)	$60.09	4.1%
Power Financial (PWF)	$29.80	4.7%
Boardwalk REIT (BEI.UN)	$36.24	5.0%
TD Bank (TD)	$64.27	3.8%
BCE (BCE)	$26.99	6.0%
George Weston (WN)	$63.42	2.3%
Shaw Communications (SJR.B)	$21.41	3.9%
Thomson Reuters (TRI)	$34.14	3.5%
Cineplex Galaxy (CGX.UN)	$17.83	7.1%
CN Rail (CNR)	$56.60	1.8%
Toromont (TIH)	$26.60	2.3%
Husky Energy (HSE)	$28.90	4.2%
Vermilion Energy (VET.UN)	$31.15	7.3%
TransCanada Corp (TRP)	$35.92	4.2%
Enbridge (ENB)	$48.08	3.5%
Pembina Pipeline (PIF.UN)	$17.18	9.1%
EnCana (ECA)	$32.69	2.6%
Average yield		**4.36%**

Income Trusts and REITs

The next 18 months will be a busy time for income trusts. With the introduction of the Tax Fairness Plan (TFP) in October 2006, most income trusts will be subject to corporate taxation starting in 2011. As a result, their boards of directors will have some important decisions to make in relation to the level of distributions paid and their corporate status. Over the last few months we have seen some income trust valuations negatively impacted by their decision to convert back to a corporation when the decision was accompanied by a distribution cut.

From a valuation perspective, we do not believe that the risk of distribution cuts has been priced into the current trading price for all business trusts. As we head into 2011, we believe that there is more downside risk than upside potential and have consequently been recommending that investors address their income trusts holdings ahead of 2011. As the tax holiday comes to an end for income trusts, investors must choose between selling their income trust holdings or receiving distributions at the risk of experiencing capital losses. Starting in 2011, many income trusts will likely be forced to cut distributions in order to fund their tax obligations.

Given that income-oriented investors are the dominant holders of income trusts, any strategic decision that cuts distributions or threatens the sustainability of the distribution has resulted in a negative impact on the income trust's valuation. In general, income trusts that have reduced distributions have experienced a double-digit decline in the unit price. Following the drop in the unit price, the market value tends to remain under pressure as investors readjust their portfolios. In some instances, some of these companies will overshoot to the downside and may represent good buying opportunities.

From a taxation perspective post-2011, distributions paid by REITs will continue to be mostly taxed as interest income while dividends paid by income trusts will be taxed at the lower dividend income rate.

Recommendation

We recommend investors reduce their exposure to income trusts at risk of cutting distributions and consider switching into higher-quality income trusts or dividend-paying stocks with sustainable payouts. Through the Equity Income Guided Portfolio process, we have identified the majority of trusts that have strong fundamentals and which we believe will maintain or increase their current level of distributions post-2011.

Income Trusts on the Equity Income Guided Portfolio Grid include:

- Bell Aliant (BA.UN)
- Cineplex Galaxy (CGX.UN)
- Vermilion Energy (VET.UN)
- Pembina Pipeline (PIF.UN)
- Keyera Facilities (KEY.UN)
- Inter Pipeline Fund (IPL.UN)
- Canadian Oil Sands (COS.UN)
- Fort Chicago (FCE.UN)
- Northland Power (NPI.UN)
- CML Healthcare (CLC.UN)*
- Westshore Terminals (WTE.UN)**
- Labrador Iron Ore (LIF.UN)**

In general, REITs (which will mostly be exempt from taxation) and Infrastructure Trusts (Power, Pipelines and Midstreams business - with their large tax pools) are best positioned to maintain their current level of distribution post-2011. As such, our recommendations in the income trust sector are heavily weighted in these sectors.

REITS on the Equity Income Guided Portfolio Grid include:

- Boardwalk REIT (BEI.UN)
- Calloway REIT (CWT.UN)
- H&R REIT (HR.UN)
- Allied Properties (AP.UN)
- Northern Properties (NPR.UN)

From a trading perspective, investors who are able to act on a timely basis may have an opportunity to purchase good quality trusts shortly after they announce their lower payout ratios. From past experience, a distribution cut is usually negatively received by the market and the unit price tends to overshoot to the downside as long-time yield investors look to exit the stock. In our opinion, that is when savvy investors should be purchasing these companies.

Quality income trusts which are at risk of reducing distributions, and which may present such buying opportunities include:

- CML Healthcare (CLC.UN)
- Alta Gas (ALA.UN)
- Innergex (IEF.UN)
- Genivar (GVR.UN)

*CML Healthcare will announce their dividend policy in the first quarter of 2010. We believe the distribution level will be reduced. RBC CM is not yet forecasting a distribution cut.

**Westshore and Labrador pay quarterly distributions based on the cash flows for the quarter. These distributions should not be considered to be stable as they are highly dependent on volumes or changes in commodity prices.

5-year government ladder

5-Year Gov Ladder	Issuer	ADP	%	Offer Price	Offer Yield	DBRS	S&P
ONT 4 19MAY10	Province of Ontario	5695872	20%	101.42	0.20%	AAL	AA-
CMBT 4.05 15MAR11	Canada Housing Trust	5703856	20%	103.82	0.85%	AAA	AAA
ONT 4.5 2DEC12	Province of Ontario	5BCGYQ0	20%	106.43	2.21%	AAL	AA-
CMBT 3.6 15JUN13	Canada Housing Trust	5BCXMT4	20%	103.84	2.43%	AAA	AAA
FINQ 3.25 1JUN14	Financement Quebec	5BFNFX3	20%	101.21	2.95%	AH	A+

5-year government/corporate ladder

5-yr Gov/Corp Ladder	Issuer	ADP	%	Offer Price	Offer Yield	DBRS	S&P
GECC 3.65 7JUN10 NC	GE Capital Corp	5697348	10%	101.33	0.49%		AA+
CAT 4.34 6DEC10 NC	Caterpillar	5703376	10%	103.38	0.65%	A	A
ONT 4 19MAY10	Province of Ontario	5695872	0%	101.42	0.20%	AAL	AA-
CMBT 4.05 15MAR11	Canada Housing Trust	5703856	20%	103.82	0.85%	AAA	AAA
CMBT 4 15JUN12	Canada Housing Trust	5973581	20%	105.03	1.90%	AAA	AAA
BNS 5.3 31JAN18 FF 13	Bank of Nova Scotia	5BCRQW2	20%	107.81	2.64%	AAL	A+
FINQ 3.25 1JUN14	Financement Quebec	5BFNFX3	20%	101.21	2.95%	AH	A+

10-year government/corporate ladder

10-yr Gov/Corp Ladder	Issuer	ADP	%	Offer Price	Offer Yield	DBRS	S&P
GECC 3.65 7JUN10 NC	GE Capital Corp	5697348	10%	101.33	0.49%		AA+
CMBT 4.05 15MAR11	Canada Housing Trust	5703856	10%	103.82	0.85%	AAA	AAA
CMBT 4 15JUN12	Canada Housing Trust	5973581	10%	105.03	1.90%	AAA	AAA
CMBT 3.6 15JUN13	Canada Housing Trust	5BCXMT4	10%	103.84	2.43%	AAA	AAA
FINQ 3.25 1JUN14	Financement Quebec	5BFNFX3	10%	101.21	2.95%	AH	A+
YYZ 5 1JUN15 C+20	Toronto Airport Authority	5694295	10%	106.87	3.59%	A	A
ONT 4.4 8MAR16	Province of Ontario	5803530	10%	105.29	3.44%	AAL	AA-
B 5 15FEB17 D+18.5	Bell Canada	5694445	10%	102.71	4.55%	AL	BBB+
ONT 4.2 8MAR18	Province of Ontario	5BCXLC0	10%	101.51	3.98%	AAL	AA-
SNC 6.19 3JUL19 D+69	SNC Lavalin	5BFYWK9	10%	106.89	5.26%	BBBH	BBB+

10-year government ladder

10-yr Gov Ladder	ADP	%	Offer Price	Offer Yield	DBRS	S&P
CMBT 3.55 15SEP10	5699422	10%	102.17	0.46%	AAA	AAA
CMBT 4.05 15MAR11	5703856	10%	103.82	0.85%	AAA	AAA
CMBT 4 15JUN12	5973581	10%	105.03	1.90%	AAA	AAA
CMBT 3.6 15JUN13	5BCXMT4	10%	103.84	2.43%	AAA	AAA
FINQ 4.25 1MAR14	5803008	10%	105.54	2.83%	AH	A+
NB 4.5 4FEB15	5694141	10%	106.43	3.12%	AH	AA-
ONT 4.4 8MAR16	5803530	10%	105.29	3.44%	AAL	AA-
PQ 4.5 1DEC17	5937038	10%	103.72	3.95%	AH	A+
ONT 4.2 8MAR18	5BCXLC0	10%	101.51	3.98%	AAL	AA-
CAN 3.75 1JUN19	5BDZBG6	10%	100.92	3.63%	AAA	AAA

Required Disclosures

Explanation of RBC Capital Markets Rating System

An analyst's "sector" is the universe of companies for which the analyst provides research coverage. Accordingly, the rating assigned to a particular stock represents solely the analyst's view of how that stock will perform over the next 12 months relative to the analyst's sector.

Ratings:

Top Pick (TP): Represents best in Outperform category; analyst's best ideas; expected to significantly outperform the sector over 12 months; provides best risk-reward ratio; approximately 10% of analyst's recommendations.

Outperform (O): Expected to materially outperform sector average over 12 months.

Sector Perform (SP): Returns expected to be in line with sector average over 12 months.

Underperform (U): Returns expected to be materially below sector average over 12 months.

Risk Qualifiers (any of the following criteria may be present):

Average Risk (Avg): Volatility and risk expected to be comparable to sector; average revenue and earnings predictability; no significant cash flow/financing concerns over coming 12-24 months; fairly liquid.

Above Average Risk (AA): Volatility and risk expected to be above sector; below average revenue and earnings predictability; may not be suitable for a significant class of individual equity investors; may have negative cash flow; low market cap or float.

Speculative (Spec): Risk consistent with venture capital; low public float; potential balance sheet concerns; risk of being delisted.

Distribution of Ratings, Firmwide

For purposes of disclosing ratings distributions, regulatory rules require member firms to assign all rated stocks to one of three rating categories-Buy, Hold/Neutral or Sell-regardless of a firm's own rating categories. Although RBC Capital Markets' stock ratings of Top Pick/Outperform, Sector Perform and Underperform most closely correspond to Buy, Hold/Neutral and Sell, respectively, the meanings are not the same because our ratings are determined on a relative basis (as described above).

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Figure 1

Distribution of ratings, firmwide
RBC Capital Markets

			Investment Banking Serv./Past 12 Months	
Rating	**Count**	**Percent**	**Count**	**Percent**
Buy (TP/O)	592	49.79	185	31.25
Hold (SP)	527	44.32	119	22.58
Sell (U)	70	5.89	4	5.71

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