Wealth Management
Dominion Securities

Dividend investing: Be patient and cast a wider net

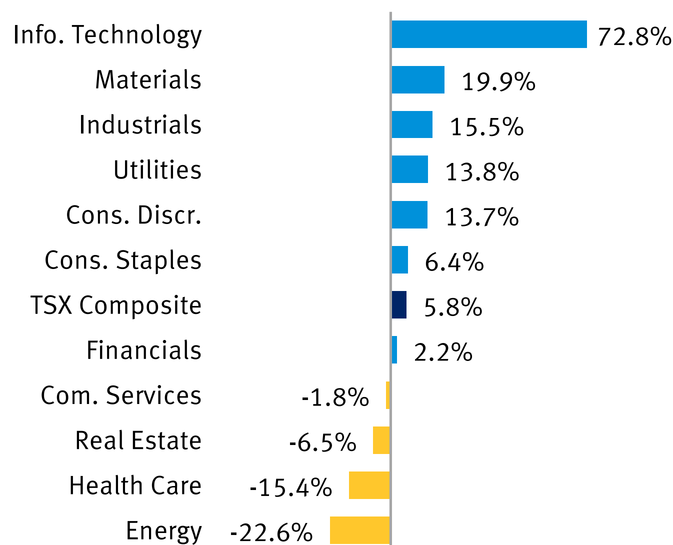
While dividend strategies may have frustrated some investors this year, we believe it's prudent to maintain discipline and focus on enhancing the quality of dividend portfolios.

The highly uneven economic fallout from the pandemic has been a notable headwind weighing on the performance of some dividend-paying sectors that investors have traditionally relied upon to navigate periods of market turmoil. As the COVID-19 health crisis subsides, the economic recovery gathers momentum, and worries about dividend sustainability fade, we believe the outlook for dividend equity strategies will continue to improve in the year ahead.

Making sense of a middling year for dividends

During times of severe market turbulence, the appeal of dividend investing typically shines through by providing investors with stable income and a smoother ride compared to the broad market. While this has been the case over the long term, especially during recessionary periods, this year's economic downturn has proved unusually challenging for some dividend portfolios.

A lopsided year for TSX sector performance



Source - RBC Wealth Management, Bloomberg; data through 12/4/20

When we drill down to it, we believe the highly uneven impact of the pandemic felt across sectors in this recession has played a significant role behind the mediocre performance of some dividend strategies this year (see chart).

While the pandemic-induced recession has been painful for most businesses, it has actually buoyed certain sectors. Amongst others, these include the Info Tech and Materials sectors, with the former benefitting from robust demand thanks to the ongoing work-from-home trend and social-distancing restrictions and the latter from higher gold prices. Collectively constituting roughly 25% of the S&P/TSX Composite Index, these two groups rank amongst the best-performing sectors in Canada year to date. However, companies in these sectors are typically underrepresented in dividend portfolios due to either low absolute income yields or a lack of reliability in cash flows, or both.

Meanwhile, the Financials, Communication Services, Real Estate, and Energy (Pipelines) sectors—which have historically provided investors with consistent and/or above-average income streams and thus often feature prominently in dividend portfolios—have trailed the market as they have borne a disproportionate amount of the negative impact stemming from some of the unique circumstances caused by COVID-19.

In the case of the Canadian banks, uncertainty over the amount of loan losses from the recession has suppressed both earnings and valuations, while a lack of clarity on the pace of the oil demand rebound has weighed on the Energy sector. For telecom companies, which reside in the Communication Services sector, reduced sales of new wireless handsets due to physical retail store closures and a temporary loss of revenue from roaming and overage charges have undermined

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sentiment. Meanwhile, disruptions ranging from work-from-home and e-commerce to severe COVID-19 outbreaks at senior care facilities have pressured office, retail, and senior-living REITs.

More broadly, amid intensified concerns about dividend suspensions, cuts, and sustainability in the face of the deepest recession in decades, dividend-paying stocks as a group suffered a steeper downward re-rating of their valuation multiples compared to the broad market.

A brightening outlook for dividends

As we gradually move past the worst of the recession storm wrought by the pandemic, we believe the outlook for dividend strategies will continue to steadily improve on the back of several developments.

Encouragingly, we believe the worst phase of dividend cuts and suspensions is likely behind us. In the first six months of 2020, approximately 60 Canadian companies cut or suspended their dividends. This is the largest amount of annual dividend cuts or suspensions over the last 14 years, including the 51 cuts or suspensions recorded in 2009 in the midst of the global financial crisis. Importantly, the number of dividend cuts has dwindled, from 29 in May to zero in September. In fact, the pace of dividend increases, 66 since the start of July, has far surpassed the number of dividend cuts over the same period.

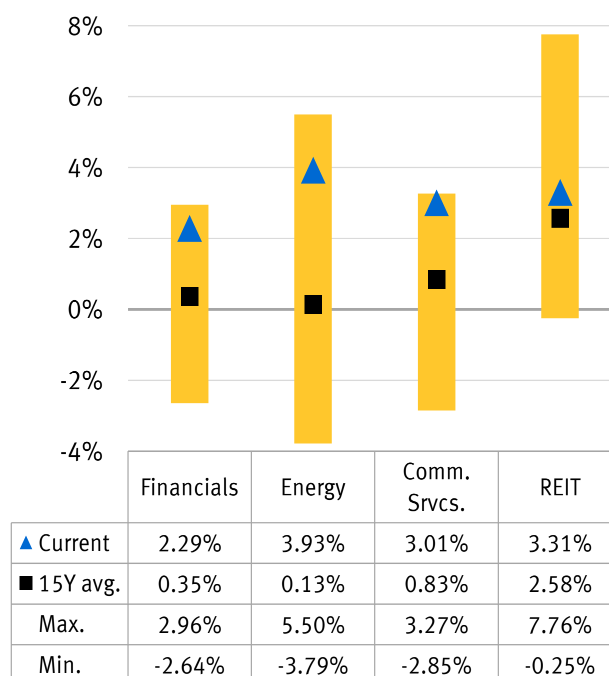
Meanwhile, we believe the recent positive vaccine news bodes well for the growth outlook. Promising efficacy data from leading COVID-19 vaccine candidates give us greater confidence that the next economic "restart" will prove more durable. As the vaccine rollout gathers steam, this should help pave the way for a greater normalization of activities in segments of the economy and equity market that have been hit harder by the pandemic, including the Financials, Communication Services, Real Estate, and Energy sectors.

For income investors, in an environment of extremely low bond yields, dividend stocks stand out as a potential alternative source of cash flows, and valuations are attractive. This is particularly the case with major Canadian dividend sectors, whose yield advantages over corporate bonds are not only above their long-term averages but in many cases are near the top end of the range since 2005 (see chart).

Related to the firming economic outlook, we see the balance of risks for longer-term bond yields as modestly tilted to the upside. As global growth moves past the near-term soft patch induced by the latest round of lockdown restrictions aimed at taming COVID-19

Equity dividends hold an attractive income edge over bonds

Dividend yield minus investment-grade corporate bond yield



	Financials	Energy	Comm. Srvcs.	REIT
▲ Current	2.29%	3.93%	3.01%	3.31%
■ 15Y avg.	0.35%	0.13%	0.83%	2.58%
Max.	2.96%	5.50%	3.27%	7.76%
Min.	-2.64%	-3.79%	-2.85%	-0.25%

Source - RBC Wealth Management, Bloomberg; data through 12/4/20

infections, bond yields will likely have some room to push incrementally higher from current depressed levels. Along with strong capital positions, better-than-forecast credit loss provisions, and the prospect that Canadian regulators could lift the moratorium on dividend hikes and share buybacks for the Canadian banks in H2 2021, this should augment the relative performance of the Financials sector in the year ahead.

Quality, sustainability, and diversification

Although concerns about the long-term impact of this year's recession on some sectors (such as Real Estate) are likely to linger, the foundation for building and managing dividend portfolios perseveres.

Selectivity remains a crucial theme and we continue to advocate a focus on companies that demonstrate what we see as the requisite quality attributes worthy of inclusion in dividend portfolios: resilient business models, reliable cash flows, a consistent and sustainable yield, dividend growth capacity, and healthy balance sheets.

We believe dividend growth in Canada will be somewhat muted as most companies remain focused on shoring up balance sheets in the aftermath of the recession. Nevertheless, we still expect some dividend increases

in certain sectors. On this front, we see select timely opportunities for attractive and growing dividends in the Consumer Staples, Utilities, Industrials, and Energy (specifically Pipelines) sectors.

Beyond that, we think a key lesson informed by this year's market turmoil is that investors should consider casting their dividend nets a bit wider in order to achieve greater diversification of income sources across both sectors and geographies in portfolios. This would be particularly important for sectors where the opportunity set is more constrained in Canada, such as Info Tech and Health Care.

A marathon, not a sprint

Despite the mediocre run of dividend strategies this year, we believe the merits of dividend investing remain unchanged. The long-term case of dividend strategies is underpinned by several secular trends that are likely to remain in place in coming years.

Against a backdrop of persistently low bond yields and rising demand for income, we expect dividend equity strategies to remain a compelling investment approach investors rely upon to help meet their long-term cash flow needs. As interest rates around the world have fallen, the total value of higher-quality bonds with negative yields recently reached nearly $17.5 trillion, accounting for roughly 26% of the entire global investment-grade bond market (see chart below).

Moreover, dividends have almost always increased over time, and decomposing long-term equity returns reveals that dividends have historically served as an essential source of total returns for equity markets. Over the past 30 years, dividends have constituted roughly one-third of the average annual total return for the TSX.

Another long-term advantage for dividend-paying companies is that they have historically outperformed the broad market by a sizable margin while doing so with considerably lower variability (see charts).

While dividend strategies may have frustrated some investors this year amid a global health crisis that has brought with it some unique challenges for traditional equity income sectors, we believe investors should maintain discipline and focus on enhancing the quality of their dividend portfolios as we navigate the next phase of the economic recovery.

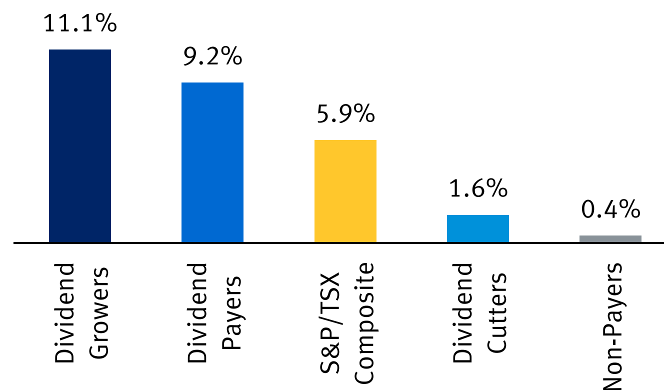
Diminishing income prospects in the bond market

Market value of global negative-yielding bonds as % of total outstanding bonds

Source - RBC Wealth Management, Bloomberg; data through 12/4/20; proxied by the Bloomberg Barclays Global Aggregate Negative Yielding Debt Index

Dividend-paying stocks hold a performance edge over time

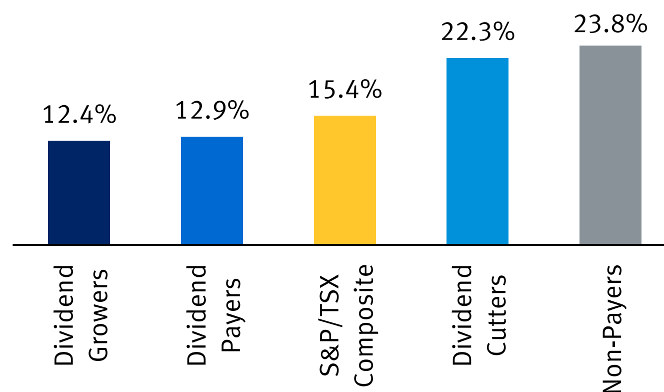
Compound annual total returns (1986–2019)



Source - RBC Capital Markets Quantitative Research; data is calculated on an equal-weight basis, S&P/TSX Composite Total Return Index, December 1986–December 2019; Growers, Cutters, Payers, and Non-Payers determined yearly

Dividend-paying stocks also exhibit lower volatility over the long run

Annualized volatility (1986–2019)



Source - RBC Capital Markets Quantitative Research; annualized volatility is calculated on an equal-weight basis, S&P/TSX Composite Total Return Index, December 1986–December 2019

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Authors

Joseph Wu, CFA
Portfolio Manager
joseph.wu@rbc.com; RBC Dominion Securities Inc.

Dominick Hardy, CA, CFA, CPA
Senior Portfolio Manager
dominick.hardy@rbc.com; RBC Dominion Securities Inc.

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