Dividend investing: Be patient and cast a wider net

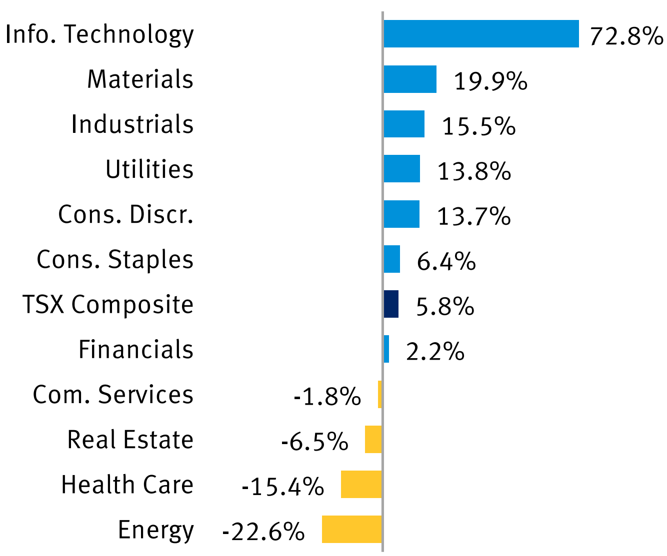
While dividend strategies may have frustrated some investors this year, we believe it's prudent to maintain discipline and focus on enhancing the quality of dividend portfolios.

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

All values in Canadian dollars and priced as of Dec. 4, 2020 market close, unless otherwise noted.
Produced: Dec. 11, 2020 09:19ET; Disseminated: Dec. 14, 2020 07:30ET

For distribution in Canada only; for important disclosures and authors' contact information see page 4.

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.

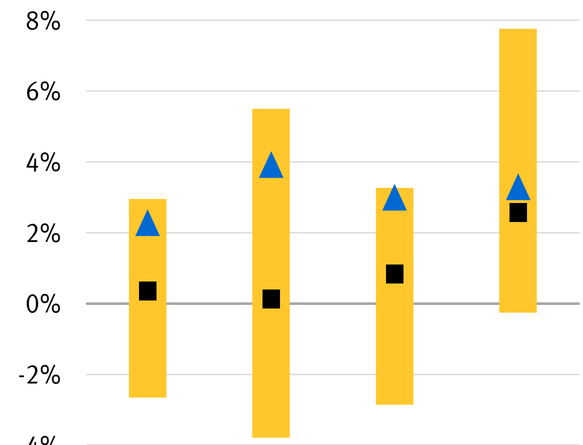
Meanwhile, we believe the recent positive vaccine news bodes well for the growth outlook. Promising efficacy data from leading COVID-19 vaccine candidates give us greater confidence that the next economic "restart" will prove more durable. As the vaccine rollout gathers steam, this should help pave the 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.

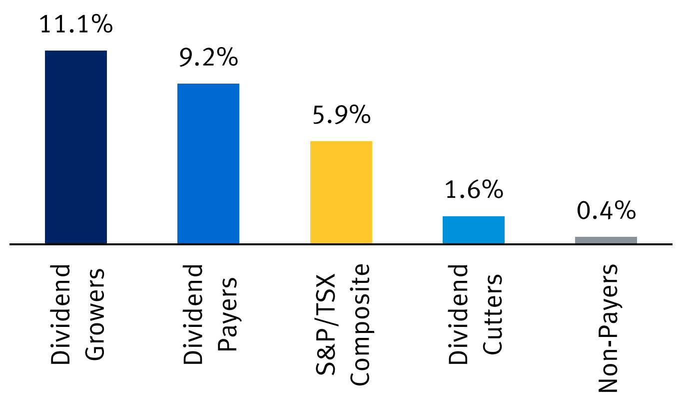
Diminishing income prospects in the bond market

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

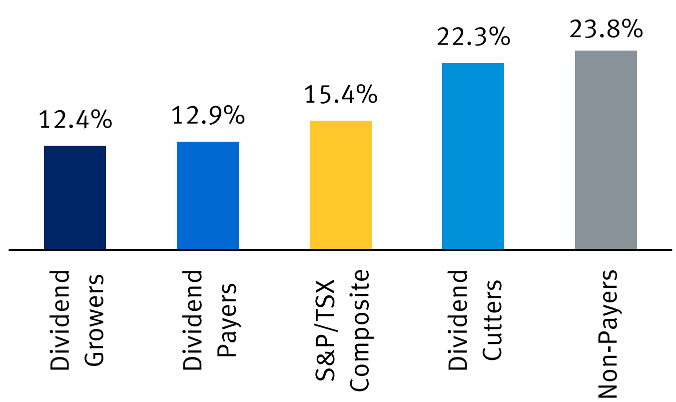
Compound annual total returns (1986–2019)



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

Disclosures and disclaimers

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.

Analyst Certification

All of the views expressed in this report accurately reflect the personal views of the responsible analyst(s) about any and all of the subject securities or issuers. No part of the compensation of the responsible analyst(s) named herein is, or will be, directly or indirectly, related to the specific recommendations or views expressed by the responsible analyst(s) in this report.

This report is issued by the Portfolio Advisory Group ("PAG") which is part of the retail division of RBC Dominion Securities Inc. ("RBC DS"). The PAG provides portfolio advisory services to RBC DS Investment Advisors. Reports published by the PAG may be made available to clients of RBC DS through its Investment Advisors. The PAG relies on a number of different sources when preparing its reports including, without limitation, research reports published by RBC Capital Markets ("RBC CM"). RBC CM is not independent of RBC DS or the PAG. RBC CM is a business name used by Royal Bank of Canada and certain of its affiliates, including RBC DS, in connection with its corporate and investment banking activities. As a result of the relationship between RBC DS, the PAG and RBC CM, there may be conflicts of interest relating to the RBC CM analyst that is responsible for publishing research on a company referred to in a report issued by the PAG.

Required Disclosures

With respect to the companies that are the subject of this publication, clients may access current disclosures of RBC Wealth Management and its affiliates by accessing our web site at https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?EntityID=2 or by mailing a request for such information to RBC Wealth Management Research Publishing, 60 South Sixth Street, Minneapolis, MN 55402

RBC Capital Markets' Distribution of Ratings

For purposes of ratings distributions, regulatory rules require member firms to assign ratings to one of three rating categories – Buy, Hold/Neutral, or Sell – regardless of a firm's own rating categories. Although RBC Capital Markets' ratings of Outperform (O), Sector Perform (SP), and Underperform (U) 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.

Distribution of Ratings - RBC Capital Markets, LLC Equity Research
As of September 30, 2020

			Investment Banking Services Provided During Past 12 Months	
Rating	Count	Percent	Count	Percent
Buy [Outperform]	788	52.96	248	31.47
Hold [Sector Perform]	619	41.60	135	21.81
Sell [Underperform]	81	5.44	11	13.58

Explanation of RBC Capital Markets' Equity 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 average.

Ratings:

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. **Restricted (R):** RBC policy precludes certain types of communications, including an investment recommendation, when RBC is acting as an advisor in certain merger or other strategic transactions and in certain other circumstances. **Not Rated (NR):** The rating, price targets and estimates have been removed due to applicable legal, regulatory or policy constraints which may include when RBC Capital Markets is acting in an advisory capacity involving the company.

As of March 31, 2020, RBC Capital Markets discontinued its Top Pick rating. Top Pick rated securities represented an analyst's best idea in the sector; expected to provide significant absolute returns over 12 months with a favorable risk-reward ratio. Top Pick rated securities have been reassigned to our Outperform rated securities category, which are securities expected to materially outperform sector average over 12 months.

Risk Rating:

The **Speculative** risk rating reflects a security's lower level of financial or operating predictability, illiquid share trading volumes, high balance sheet leverage, or limited operating history that result in a higher expectation of financial and/or stock price volatility.

RBC Capital Markets analysts have received (or will receive) compensation based in part upon the investment banking revenues of RBC Capital Markets.

RBC Capital Markets Conflicts Policy

RBC Capital Markets Policy for Managing Conflicts of Interest in Relation to Investment Research is available from us on request. To access our current policy, clients should refer to https://www.rbccm.com/global/file-414164.pdf or send a request to RBC Capital Markets Research Publishing, P.O. Box 50, 200 Bay Street, Royal Bank Plaza, 29th Floor, South Tower, Toronto, Ontario M5J 2W7. We reserve the right to amend or supplement this policy at any time.

Dissemination of Research & Short Term Ideas

RBC Capital Markets endeavours to make all reasonable efforts to provide research simultaneously to all eligible clients, having regard to local time zones in overseas jurisdictions. Subject to any applicable regulatory considerations, “eligible clients” may include RBC Capital Markets institutional clients globally, the retail divisions of RBC Dominion Securities Inc. and RBC Capital Markets LLC, and affiliates. RBC Capital Markets’ equity research is posted to our proprietary websites to ensure eligible clients receive coverage initiations and changes in rating, targets and opinions in a timely manner. Additional distribution may be done by the sales personnel via email, fax or regular mail. Clients may also receive our research via third party vendors. Please contact your investment advisor or institutional salesperson for more information regarding RBC Capital Markets research. RBC Capital Markets also provides eligible clients with access to SPARC on its proprietary INSIGHT website. SPARC contains market color and commentary, and may also contain Short-Term Trade Ideas regarding the securities of subject companies discussed in this or other research reports. A Short-Term Trade Idea reflects the research analyst’s directional view regarding the price of the security of a subject company in the coming days or weeks, based on market and trading events. A Short-Term Trade Idea may differ from the price targets and/or recommendations in our published research reports reflecting the research analyst’s views of the longer-term (one year) prospects of the subject company, as a result of the differing time horizons, methodologies and/or other factors. Thus, it is possible that the security of a subject company that is considered a long-term ‘Sector Perform’ or even an ‘Underperform’ might be a short-term buying opportunity as a result of temporary selling pressure in the market; conversely, the security of a subject company that is rated a long-term ‘Outperform’ could be considered susceptible to a short-term downward price correction. Short-Term Trade Ideas are not ratings, nor are they part of any ratings system, and RBC Capital Markets generally does not intend, nor undertakes any obligation, to maintain or update Short-Term Trade Ideas. Short-Term Trade Ideas discussed in SPARC may not be suitable for all investors and have not been tailored to individual investor circumstances and objectives, and investors should make their own independent decisions regarding any Short-Term Trade Ideas discussed therein.

Conflict Disclosures

In the event that this is a compendium report (covers six or more subject companies), RBC DS may choose to provide specific disclosures for the subject companies by reference. To access RBC CM’s current disclosures of these companies, please go to https://www.rbccm.com/GLDisclosure/PublicWeb/DisclosureLookup.aspx?entityId=1.

Such information is also available upon request to RBC Dominion Securities, Attention: Manager, Portfolio Advisory Group, 155 Wellington Street West, 17th Floor, Toronto, ON M5V 3K7.

The authors are employed by RBC Dominion Securities Inc., a securities broker-dealer with principal offices located in Toronto, Canada.

The Global Industry Classification Standard (“GICS”) was developed by and is the exclusive property and a service mark of MSCI Inc. (“MSCI”) and Standard & Poor’s Financial Services LLC (“S&P”) and is licensed for use by RBC. Neither MSCI, S&P, nor any other party involved in making or compiling the GICS or any GICS classifications makes any express or implied warranties or representations with respect to such standard or classification (or the results to be obtained by the use thereof), and all such parties hereby expressly disclaim all warranties of originality, accuracy, completeness, merchantability and fitness for a particular purpose with respect to any of such standard or classification. Without limiting any of the foregoing, in no event shall MSCI, S&P, any of their affiliates or any third party involved in making or compiling the GICS or any GICS classifications have any liability for any direct, indirect, special, punitive, consequential or any other damages (including lost profits) even if notified of the possibility of such damages.

References herein to “LIBOR”, “LIBO Rate”, “L” or other LIBOR abbreviations means the London interbank offered rate as administered by ICE Benchmark Administration (or any other person that takes over the administration of such rate).

Disclaimer

The information contained in this report has been compiled by RBC Dominion Securities Inc. (“RBC DS”) from sources believed by it to be reliable, but no representations or warranty, express or implied, are made by RBC DS or any other person as to its accuracy, completeness or correctness. All opinions and estimates contained in this report constitute RBC DS’ judgment as of the date of this report, are subject to change without notice and are provided in good faith but without legal responsibility. This report is not an offer to sell or a solicitation of an offer to buy any securities. Additionally, this report is not, and under no circumstances should be construed as, a solicitation to act as securities broker or dealer in any jurisdiction by any person or company that is not legally permitted to carry on the business of a securities broker or dealer in that jurisdiction. This material is prepared for general circulation to Investment Advisors and does not have regard to the particular circumstances or needs of any specific person who may read it. RBC DS and its affiliates may have an investment banking or other relationship with some or all of the issuers mentioned herein and may trade in any of the securities mentioned herein either for their own account or the accounts of their customers. RBC DS and its affiliates may also issue options on securities mentioned herein and may trade in options issued by others. Accordingly, RBC DS or its affiliates may at any time have a long or short position in any such security or option thereon. Neither RBC DS nor any of its affiliates, nor any other person, accepts any liability whatsoever for any direct or consequential loss arising from any use of this report or the information contained herein. No matter contained in this document may be reproduced or copied by any means without the prior written consent of RBC DS in each instance.

In all jurisdictions where RBC Capital Markets conducts business, we do not offer investment advice on Royal Bank of Canada. Certain regulations prohibit member firms from soliciting orders and offering investment advice or opinions on their own stock. References to Royal Bank are for informational purposes only and not intended as a direct or implied recommendation for investing in Royal Bank and all related securities.

RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. is a member company of RBC Wealth Management, a business segment of Royal Bank of Canada. ®Registered trademarks of Royal Bank of Canada. Used under licence.