Wealth Management
Dominion Securities

MARCH '24 EDITION

not your ORDinary newsletter

A Diversified Strategy for Retirement Income can Really Pay Dividends!

Written by: JOHN ORD & TIM WALLER

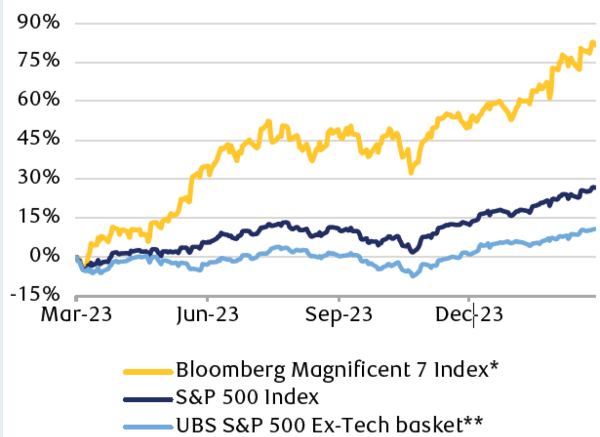
ORD PRIVATE WEALTH MANAGEMENT
RBC Dominion Securities Inc.

When a client tells us, "I need dividend income in retirement", what they are really saying is "I need MONEY to fund my expenses in retirement". The source of that money doesn't necessarily have to come strictly from dividends but many retail investors consider large dividend paying stocks as "safer" and desire the higher cash flow that comes along with them. However, what can get lost in that way of thinking is the fact that **many of the most well-managed; profitable; and innovative companies in the world today do not pay their shareholders a large dividend.** If you focus solely on stocks that pay out significant cash dividends, you would have missed out on owning many of these companies. As we continue to see a "March break" out to new highs in the US stock market, we're going to take the opportunity this month to focus our attention on this important question: **"How should I fund my retirement income needs?".** We suggest that the best answer to this question is a little more nuanced than "Own dividend stocks!".

Before we dive into the strategy discussion, let's take a quick look at the recent past in the stock market. In the past year and a half, there has been a tremendous run from many growth stocks, including the famed "Magnificent 7" that have received so much focus in the media. There is good reason for all the attention, as the chart below shows just how much these stocks have outperformed the broader market since March of 2023. **Without the return from Technology-related stocks, the S&P 500's gains in the past 12 months would have been cut by more than half.**

Magnificent 7 stocks surged over the past year

One-year U.S. large-capitalization equity returns



* The Bloomberg Magnificent 7 Index tracks Apple, Microsoft, Alphabet, Amazon.com, NVIDIA, Tesla, and Meta Platforms.

** The UBS S&P 500 Ex-Tech basket tracks the performance of the S&P 500 excluding the Information Technology and Communication Services sectors, plus Tesla and Amazon. Effectively, this excludes technology-related stocks in the S&P 500.

Source - Bloomberg, RBC Wealth Management; data range 3/6/23–3/4/24; price returns (not including dividends)

Notably, of the Magnificent 7, only 4 of them pay any cash dividend to shareholders (Apple, Microsoft, Meta and Nvidia). The amount of these dividends is relatively insignificant as all 4 companies have current dividend yields well under 1%. In fact, Nvidia's dividend is only 0.02% (after the stock's latest effort to rocket straight toward the moon) and Meta has only initiated their dividend very recently.

Figure 2: S&P 500 Companies Relative Performance: Top Share Repurchases vs. Top Capital Expenditures
(indexed to 100 on December 31, 2007)

Source: Strategas Research Partners, as of December 31, 2023. Chart represents relative performance of top quintile of S&P 500 firms for share repurchases vs. top quintile of S&P 500 firms for capital expenditures. Constituents for share repurchases are based on the company's dollar value of share repurchases over the trailing 12 months as a percent of average shareholders' equity. Constituents for capital expenditures are rebalanced monthly and based on the year-over-year percent change in capital expenditures.

Where these companies really provide additional shareholder value is with their share buyback strategy. A company that repurchases their own shares is effectively reducing the available stock that the public can invest in, also known as "lowering supply". As any economist will tell you: **lowering supply without affecting demand will lead to an increase in price.** Looking back on the past 17 years, we can see that **investors have been handsomely rewarded by owning companies that have been the biggest repurchasers of their own stock,** returning about 2.5 times more over that time frame than companies that are asset-heavy and have the highest capital expenditures, including many with big dividend yields (see chart above).

How a company chooses to spend their cash flow has really mattered to the bottom line of investors in the past couple of decades. By not being locked into paying a large dividend, this has allowed companies to have more spending flexibility and be opportunistic with their cash flows to benefit shareholders. As an investor, you do not have to rely solely on dividends to fund your retirement when you have proper asset allocation and a disciplined rebalancing strategy. **Dividends are only one aspect of providing for your financial future and do not need to be the only tool in the shed.** What would this type of strategy we're talking about look like in practice?

Here are some steps outlining **how we manage income requirements for our discretionary clients' portfolios:**

1. **Start with an appropriate Asset Allocation for your portfolio between equity, fixed income & alternatives.** For your equity portion, you can own a mix of growth stocks along with quality dividend payers (known as a "Barbell" strategy). This way you are not completely shunning the best companies in the world if they don't use their cash to pay dividends, but instead use it for other purposes.

2. **Keep enough cash in your portfolio to fund the next several months of required income payments.** With current interest rates, you can even earn some decent income on that cash while not having it exposed to the market in the short-term.

3. Set up a dedicated portfolio rebalancing strategy (we prefer Semi-Annual). By doing this, you are replenishing the cash you will need by trimming some assets that have performed the best during the past several months, whether they are stocks or fixed income. It also resets your Asset Allocation back to your desired target, which is important to manage risk after major gains (or declines) in the stock market.

4. Opportunistically trim your "winners" throughout the year. This also tops up your cash bucket, while locking in profits. Should some of the high-flyers eventually come back to earth, you would have already participated in plenty of gains while having reduced your risk.

5. Fixed income (GICs and bonds) can be part of the solution now, rather than the problem. When interest rates were extremely low over the past decade, income investors could not rely on these products to offer enough return to fund their needs. Today, it is still possible to get a 5% return locked in on a low-risk asset. That opportunity may not last much longer as central banks look to start cutting interest rates later this year. During the past year, we had been purchasing GICs and bonds that return between 5% and 6% to help clients with future income needs.

6. Tax-Efficient income through capital gains. Nobody that we're aware of loves to pay taxes! Capital gains are taxed at a lower rate than either dividend income or interest. If you can supply yourself with the money you need to fund your retirement and save some tax along the way, all the better!

Some of this may sound a bit complicated or time consuming, but that's why we we're here! This strategy has served us well throughout the ups and downs of the past several years. These recent highs have given us an opportunity to "fill the bucket" for our client's income needs and we're happy to do so!

One final note this month: with the significant run in technology stocks (most prominently seen by AI-related stocks like Nvidia), we are beginning to hear comparisons made to the "Tech Bubble" of 2000. This was going to be a topic we focused more on in this month's newsletter, but it just so happens that Kelly Bogdanova of RBC Wealth Management put together a great 2-page report called "Bubble watch" in the Global Insight Weekly a few days ago (you may even recognize one of the charts). Kelly touches on many of the points we were considering, and we highly recommend clicking on that previous link to read the report as it outlines many of the key differences between then and now. While we could of course see a short-term dip in markets after this recent rally, the valuation of stocks is nowhere near the mania seen back then. **The companies today providing the biggest gains are also bringing in revenue at substantial rates,** unlike what we saw in 2000.

We hope everyone enjoys the beginning of Spring and can enjoy some time outdoors!

INCOME SPLITTING STRATEGIES

This time of year, taxes are on everyone's mind. Looking for ways to reduce taxes is a focus of tax planning for people in any financial situation. Depending on your circumstances, if you have a spouse or common-law partner who earns less income than you (or vice versa), or other family members with little to no income, income splitting could be an effective way to lower your family's overall tax bill.

Income splitting is simply a tax-planning strategy that can shift income (that would otherwise be taxed in your hands at a high marginal tax rate) to your lower-income family member, taking advantage of their lower marginal tax rate. This can be a useful way to increase your family's after-tax income, and can be accomplished through strategies such as loans; trusts and gifting.

When considering income splitting, it's important to be aware that certain "attribution rules" may prevent splitting income between family members in some circumstances. The criteria to determine if attribution applies are complex. This is why it is important to consult with a qualified tax advisor before considering any type of income splitting strategy.

Income splitting is one tool that could be implemented as part of a longer-term financial plan. The Income splitting checklist contains some strategies you may wish to consider.

Please contact our team if you are interested in learning more about which strategies may be most appropriate for you and your family, and how it can relate to your overall financial plan.

AS ALWAYS, PLEASE REACH OUT TO US DIRECTLY IF YOU HAVE ANY QUESTIONS OR CONCERNS RELATED TO YOUR PORTFOLIO.

ORD PRIVATE WEALTH MANAGEMENT

Best regards, John, David, Tim & Mikail

Respecting your privacy and preferences for electronic communications is important to us. If you would prefer not to receive emails from me, please reply with "UNSUBSCRIBE" in the subject line or body of the email. If you would also prefer not to receive emails from our firm, please cc: **unsubscribeRBCDominionSecurities@rbc.com** in your reply. Please note that you will continue to receive messages related to transactions or services that we provide to you. To speak to us about how your preferences are managed, **please email: contactRBCDominionSecurities@rbc.com**.