Portfolio Manager’s Note – February 2016

Accentuate the Positive

The one thing we were quite certain about at the beginning of the year was that volatility across equities, bonds and currencies would continue. While we take no great joy in that prediction coming true, we have learned over the years that there is little use trying to avoid volatility when investing in equities. The ups and downs of the market are the price of admission – the reward is superior long term returns, and these days, higher income than one can get from high quality bonds and GICs. What is the cost of panicking during choppy markets or chasing returns? Luckily we have uncovered some very interesting data on this.

Vanguard studied returns for the 10 years to 2013, and they found that the average U.S. mutual fund returned 6.93% annualized. The average investor in those funds, meanwhile, returned 5.54% annualized. That’s a difference of 1.39% per year, every year, or nearly 14% in total return over the ten year period. You may rightfully ask: How can this be? The answer is that investors tend to do themselves a disservice by chasing performance (buying last year’s winners) and attempting to time the market (things look bad - get me out! The coast is clear, time to buy!).

Looked at another way, we recently read of an internal study done at a large U.S. firm. They sliced and diced return data to figure out which accounts had the best performance, and the results were fascinating. The best performing accounts were actually the ones that the investors forgot they had! Talk about removing emotion from investment decisions - that takes the Warren Buffet investing mantra of "lethargy bordering on sloth" to a whole new level.

So what do the above studies tell us? The conclusion we take away is that panicking and chasing performance is not a strategy. In these volatile times, we can’t control the markets or the economy. What we can control is the securities we choose to invest in. Focusing on securities that provide dividend income and dividend growth act as a buffer to volatility, allows us to reinvest at more attractive levels, and also serves to guard against the erosion of purchasing power due to inflation.
The extreme volatility seen year to date does not line up with what we are seeing in the economy. Depending on the region, economic performance is ticking along just fine (the U.S.), slowing (China) or mixed (Europe). The data we see suggests that the probability of recession in the U.S. is just slightly above baseline levels (as one would expect in the seventh year of a cycle), but there are many securities that are coming close to fully pricing in a recession. One market that fits this description is the high yield bond market, where yields relative to government debt are near levels seen in the 1990s and 2000s recession. Another is our very own TSX. The TSX is much further along in the correction cycle than the U.S. market, and this has produced a number of bargains in high quality dividend paying securities. Examples of this would be the Canadian banks, REITs and select companies in the energy infrastructure space.

We will leave you with one of our favourite charts, and it is likely one many of you have seen before, but with a bit of a new twist. Below is the most up to date version of the historical performance of TSX constituents as determined by their dividend profiles. The index is broken up into dividend growers, dividend payers, the TSX and dividend cutters and non-payers. The broad conclusion here hasn’t changed – dividend paying and growing stocks have materially outperformed over the long term. What’s new is the results of the non-payers and dividend cutters. Historically these two sectors have only provided very low single digit returns. However, the past few quarters have not been kind to this cohort – as of year-end 2015, the data shows that in aggregate the companies that don’t pay or cut their dividend have actually lost money going back to 1986!

*** All interest rates, FX rates and yields subject to change***
We are well aware that we harp on the importance of focusing on holding dividend paying securities, and hopefully the above data puts a bit of an exclamation point as to why. Dividend payers and growers have significantly outperformed the TSX, a trend we believe will continue. Current market volatility, while uncomfortable, is opening up opportunities to buy great companies at reasonable prices and lock in strong income streams for years to come.

So, the natural question you may ask is, do I own any of these dividend growth stocks? And the answer is a resounding YES! The following securities gave you a pay raise in the form of a dividend increase in the last 12 months--> Enbridge, Inter Pipeline, Suncor, Agrium, CN Rail, Bank of Nova Scotia, Brookfield Asset Management, Manulife, Intact Financial, Royal Bank, TD Bank, BCE, Telus, Allied Properties, Loblaw’s, Emera, Brookfield Infrastructure, Honeywell, JP Morgan, Coca Cola, CVS, Nestle, Procter & Gamble, Merck, Pfizer, and Visa. In these uncertain times, management teams have realized that investors prize cold hard cash, and preferably more of it every year. **We can't tell you what the share price of any particular company will be tomorrow or the next day. What we can tell you is that if we continue to follow this discipline you will have a highly dependable cash flow stream and that over time, this method of investing has outperformed.**

The Harbour Group
416-842-2300

*Putting you first, every time, to help you navigate the complexities of managing your wealth. All of our team members, all of our resources, all of our collective insight: ALL FOR ONE: YOU™*

---

The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. RBC Dominion Securities Inc. 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 Dominion Securities Inc. and its affiliates also may issue options on securities mentioned herein and may trade in options issued by others. Accordingly, RBC Dominion Securities Inc. or its affiliates may at any time have a long or short position in any such security or option thereon. Mutual funds are sold by RBC Dominion Securities Inc. There may be commissions, trailing commissions, management fees and expenses associated with mutual fund investments. Read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPF. ©Registered Trademark of Royal Bank of Canada. Used under licence. RBC Dominion Securities is a registered trademark of Royal Bank of Canada. Used under licence. ©Copyright 2016. All rights reserved.

*** All interest rates, FX rates and yields subject to change***