feature

Surviving a Grizzly Attack

Portfolio strategies for a bear market

When faced with a turbulent stock market, investors run to and fro, eagerly searching for safe investment vehicles, with a willingness to sacrifice returns for safety of principal. At first glance, government bonds and money market instruments may seem like an ideal safe haven; however, with interest rates at historic lows, this is hardly a long-term solution.

Recent stock market rallies, amidst a sagging economic backdrop, have many economists and media pundits debating the outlook. It may be tempting to chase lofty returns, but it is too early to celebrate.

My October 2008 article in Canadian Chiropractor – titled "Keeping a Cool Head" – discussed the importance of keeping your emotions grounded, and the benefit of eliminating hindsight from your investment decisions. Now is the time to take this idea one step further, and focus on an effective strategy for surviving a *bear market* attack.

Michael S. Magreehan is an investment advisor with Lysnes / Magreehan Wealth Management at Canaccord Capital in Waterloo, Ontario. Mike welcomes your comments and questions at 1-800-495-8071 or mike_magreehan@canaccord.com.

Mike Magreehan, BBA (Hon), CFP

CASH FLOW IS KEY

A long-held belief is that dividends are a key ingredient in an investment portfolio. Not only are dividend yields higher than bond and money market rates, but dividends also offer superior tax advantages. A blue-chip dividend strategy is by no means glamorous, but during volatile times, it is one that literally pays you dividends.

Dividend-paying companies are often large-cap, mature businesses generating strong earnings. Their stable and growing dividend payouts offer your portfolio a cash-cushion in the event of any potential declines in stock price.

Cash-flow is key. Picture your chiropractic business starved of cash flow. How would you pay your staff salaries, overhead expenses and taxes, and ever hope to fund a growth opportunity? Your investment portfolio, much like your business, requires cash flow. And the more, the merrier.

SUPERIOR TAX ADVANTAGES

Thanks to the enhanced dividend tax credit, investors earn substantial tax advantages when investing in Canadian companies.

For the majority of investors, a dollar of dividends is worth 1.4 times a dollar of interest income received on an after-tax basis. Stated another way, on an after-tax basis, a four per cent dividend yield is equivalent to a 5.6 per cent bond interest yield.

For an Ontario investor earning an income of $65,000 a year, a $100 bond interest payment would net $67 after-tax, while a $100 dividend would net $92. An obvious tax savings.

Before making any investment, there are certain things to consider, including: the sector in which the company operates, the balance sheet and income quality, the length and track record of dividend payouts, the strength of management, and credit quality.

POWER YOUR PORTFOLIO

Power utilities tend to pass these tests, and therefore dividend-investors rank them among their favourites. Utilities have long-term contracts to provide an essential service.

Power utilities have growth potential that has historically yielded solid, long-term returns, superior to many other market opportunities

Utility stocks generally have a low-risk profile and pay an exceptionally consistent and growing cash stream to investors. Paying out roughly 30 per cent of cash flow, they have the ability to reinvest and grow their existing business with flexibility to finance new projects. This growth translates into higher dividends and stock prices, over time, and has historically yielded solid long-term returns that are superior to many other market opportunities.

As they increased their earnings, the Canadian utility sector also grew their dividend payouts by five per cent in 2005, nine per cent in 2006, four per cent in 2007 and nine per cent in 2008.

Utilities have historically been a good investment. The Canaccord Adams utility index – which tracks the basket of utility stocks – had a compounded annual growth rate of 12.8 per cent over the last 30 years versus 9.5 per cent for the Toronto Stock Exchange (TSX). Further, these returns were achieved with less volatility than is found in the overall stock market.

As of May 15, 2009, utility dividend yields are averaging five per cent, with room for growth in both the dividend yield and stock price. Given the economic backdrop, and with current market prices relatively low, this could be an opportune time to consider a defensive investment in a good quality dividend-paying company. •