Stocks for the long run?

By Frank Mullen, portfolio manager

The low interest rate environment that we have operated in has caused investors to look beyond traditional fixed-income portfolios in their hunt for income. The fact that government bonds, GICs and high-interest savings accounts provide paltry yields doesn't change the fact that investors need income.

One of the more interesting parts of my job is speaking to advisors about a solution for their clients' long-term investment objectives. During these conversations, many voiced frustration with trying to find income, and explaining that asset classes they thought would provide the income and stability associated with bonds are proving to be challenging.

Letting them eat cake

The financial industry capitalized on investors' need for income by touting the benefits of many asset classes, including preferred shares, emerging market bonds and option-based strategies. The most common bond alternative has been dividend-paying Canadian stocks. What's not to like? An investment that pays income and provides the potential for capital appreciation. Although it was tempting to use dividend-paying stocks as a replacement for bonds in a reach for yield, it hasn't performed the way most hoped.

Companies with the ability to pay out large portions of their earnings in dividends are usually older, more established businesses that provide a perception of safety. Clients feel comforted that these businesses are generally larger and more familiar brands in Canada. This combination of income and perceived safety drove huge inflows of capital into both individual dividend-paying stocks and portfolios that focused on the asset class. Just because clients need income doesn't mean that the market will provide it and any solution that does must include some form of risk. That risk began to rear its head when interest rates began rising in 2018 and continued as sentiment in the markets abruptly shifted.

The S&P/TSX Canadian Dividend Aristocrats Index consists of companies that steadily increased their dividends over the last five years. It's used by many as a way to invest in higher quality Canadian dividend payers. Despite its large weights in perceived safety industries like pipelines, banks and real estate investment trusts, the index struggled to perform in 2018. The index was down over 12.7%,[i] and after accounting for dividend payments, will have a negative total return of over 8.3%.[ii] While the total return beat the S&P/TSX Composite Index's return of -8.9%,[iii] I struggle to think that many investors expected their "bond alternatives" to be down such a large degree. The perception of safety has proven to be different than reality in 2018.

While 2018 is simply one year, I think it highlights that dividend-paying stocks aren't bonds. They're lower in the capital structure and most importantly lack the features that make bonds an attractive asset class. I believe that high-yield corporate bonds can provide an interesting alternative to dividend-paying equities for those willing to do the required credit work.

Many investors aren't familiar with high-yield bonds. It's common to hear advisors quickly say they "don't buy bonds", while others state that they believe they're risky. High-yield bonds have many interesting attributes that I believe represent a great way to generate income and capital appreciation in a low-interest rate world and can compete with dividend-paying stock strategies.

The importance of maturity dates

One of the main advantages of high-yield bonds over dividend-paying equities are their defined and mandatory payment obligations. Coupons and principal repayments are required to be paid, both insulating investors during some periods of volatility and can help them take advantage of market conditions.

While many investors believed that their dividend-paying stocks would behave like bonds, they missed a crucial consideration – dividend-paying stocks don't have a maturity. Excluding defaults, a high-yield investor knows when they'll receive their principal repayment. If the price of that bond declines, they can make a judgement about continuing to own the investment, knowing what the return will be to maturity. If the market undergoes a period of volatility, high-yield investors can experience mark-to-market declines but their pending maturity date generally helps to insulate price movements more than equities. The advantage of receiving coupon and interest payments during these bouts of volatility is that it allows reinvestment at higher and more attractive rates of return.

The return profile of dividend-paying stocks are more uncertain. Most of these businesses can weather the storm of a change in the economic environment, but the price of these securities can vary widely.

- Will the fundamentals of the business continue to improve or will they cycle with the economy?
- Will the dividend be protected or is there a chance that it will be reduced?
- Can the dividend payment make up for multiple contraction?

Paying a dear price for a stock that pays dividends can end up leading to these dividends being a return of your capital and not a return on your capital. Let's work through that.

Clogged piping

Pipeline companies have historically been high dividend payers. Contracts form a large part of their business and this revenue stream certainty lends itself to being able to pay shareholders a dividend. At the beginning of 2018, TransCanada Corp., one of the largest pipeline owners in the country had a dividend yield of just over 4%,[iv] about double what 10-year Government of Canada bonds paid at the time (2.045%).[v] The narrative to buy TransCanada for income was very enticing. A stable business with line-of-sight into growth projects, paying twice what an investor could get in risk-free Canadian bonds. In 2018, the investment didn't work out as planned. TransCanada's stock price fell almost 20%[vi] in 2018, equating about four years of dividend payments. Was that juicy dividend a return of your capital or a return on your capital? Only time will tell, but it highlights one of the core risks that differentiate equity investing from fixed income – no maturity date allows that principal component of your investment to be quite volatile.

The average high-yield bond has a term of approximately five years.[vii] If your credit analysis was correct, then you know your investment's return profile at the time of purchase and over its term. The price can change during your holding period, but, unlike equity investors, you're guaranteed your principal at maturity barring a default.

More than a slice - looking at the whole market

To ensure I haven't cherry picked the only dividend-paying stock that declined this year, let's look at the market as a whole. While it did better than TransCanada, it wasn't by much. Although I don't think the comparative return on the high-yield index is anything to write home about, it's substantially better than Canadian dividend-paying stocks:

	One-year return	
	Price	**Total**
ICE BofAML US High Yield Index	-8.26%	-2.26%
S&P/TSX Canadian Dividend Aristocrats Index	-12.66%	-8.29%

Source: Morningstar Direct. ICE BofAML US High Yield Index returns in US$. S&P/TSX Canadian Dividend Aristocrats Index returns in C$. As at December 31, 2018. Local currencies shown to exclude the currency impact on returns. The ICE BofAML US High Yield tracks the performance of high-yield corporate debt denominated in U.S. dollars and publicly issued in the U.S. domestic market.

2018 has been a bad year for dividend-paying stocks. If we lengthen our timeframe, how do they hold up to the return of high-yield bonds?

	1-year	3-year	5-year	10-year
ICE BofAML US High Yield Index	-2.26%	7.26%	3.82%	10.98%
S&P/TSX Canadian Dividend Aristocrats Index	-8.29%	5.76%	3.74%	11.38%

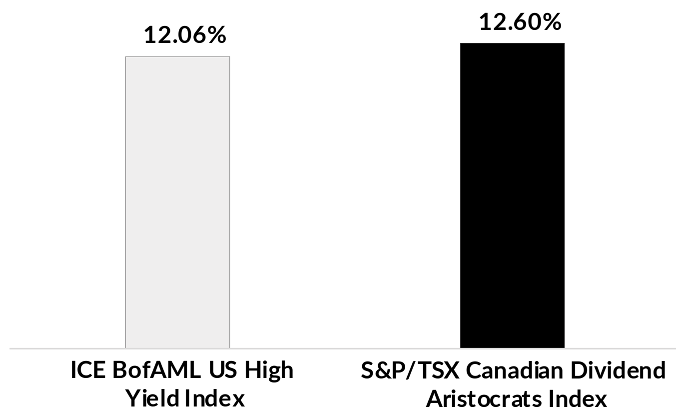
Source: Bloomberg LP. Total returns, annualized and includes reinvestment of dividends. ICE BofAML US High Yield Index returns in US$. S&P/TSX Canadian Dividend Aristocrats Index returns in C$. As at December 31, 2018.

I find these results to be very interesting. Buying dividend-paying stocks has often been touted as a great investment approach, yet high-yield bonds provide competitive return characteristics over these timeframes.

In addition, high-yield bonds also provide downside protection by allowing investors to invest in a more senior part of the capital structure. The claims of bond investors exceed those of their equity counterparts. There are scenarios where equity investments can go to zero yet bondholders get paid back in full. One would think that a more senior claim should limit downside risk, but does that show up in the data?

Average calendar-year return

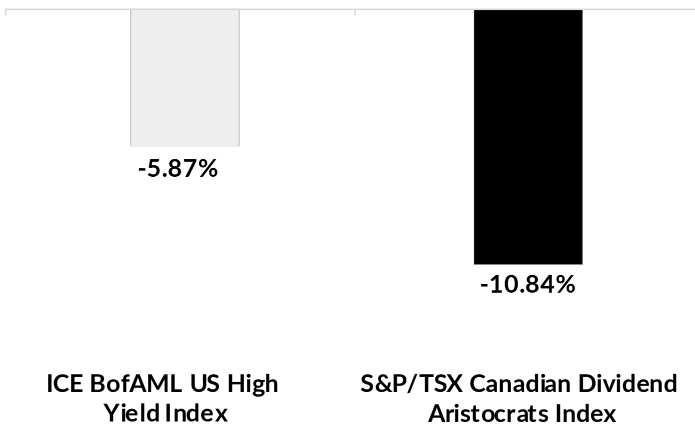
Dec. 31, 2008 to Dec. 31, 2018



Source: Bloomberg LP. Total returns, annualized and includes reinvestment of dividends. ICE BofAML US High Yield Index returns in US$. S&P/TSX Canadian Dividend Aristocrats Index returns in C$. As at December 31, 2018.

Average calendar-year maximum drawdown

Dec. 31, 2008 to Dec. 31, 2018



Source: Morningstar Direct. Total returns, includes reinvestment of dividends. ICE BofAML US High Yield Index drawdown in US$. S&P/TSX Canadian Dividend Aristocrats Index drawdown in C$. Calendar maximum decline is the largest intra-year market drop from a peak-to-trough during the calendar year.

The return and risk profiles of high-yields bonds seem to stack up quite well against dividend-paying stocks.

High-yield bonds aren't risk free. You're paid a juicy yield to take on credit risk. Companies will continue to default which can lead to negative returns. The returns shown include the defaults in the index, so historically high-yield bonds have overpaid investors for default risk.

Avoiding empty calories – the benefit of investing in individual companies

The discussion up until this point has used broad-based indices. I believe that active management can add value when investing in high-yield bonds. Companies will default, but doing the credit work to avoid losses that stem from defaults and taking advantage of volatility can provide superior returns. The chart shows EdgePoint's 10-year track record of EdgePoint Canadian Growth & Income Portfolio's high-yield holdings.

	1-year	3-year	5-year	10-year
EdgePoint Canadian Growth & Income Portfolio's high-yield holdings	3.42%	11.66%	7.71%	12.67%

Source: FactSet Research Systems Inc. As at December 31, 2018. Above EdgePoint returns are for illustrative purposes only and not indicative of future performance. They aren't representative of an actual fixed-income fund returns as they weren't investible. EdgePoint returns are gross of fees, in local currency and approximations calculated based on end-of-day holdings data (actual trading prices not captured). High-yield fixed-income returns are only for high-yield bonds (ratings lower than BBB).

The last year caused many investors to challenge their preconceived ideas about particular asset classes. There's no silver bullet in investing and I believe an approach that challenges common assumptions and strives for improvement has the highest chance of success.

We believe that high-yield bonds are often overlooked and provide opportunities to those willing to do true credit analysis. The most important part of investing is having a disciplined long-term investment approach. All of our investment decisions at EdgePoint start with analyzing a business and trying to develop a proprietary insight. This approach works across the capital structure and we're confident our active approach can add value in both our equity and credit investment ideas.

Performance as at Dec. 31, 2018 Annualized, total returns, net of fees, in C$.	YTD	1-year	3-year	5-year	10-year	Since inception*
EdgePoint Global Growth & Income Portfolio , Series A	-1.18%	-1.18%	7.30%	8.94%	11.99%	12.28%
EdgePoint Canadian Growth & Income Portfolio, Series A	-10.36%	-10.36%	4.74%	3.92%	9.26%	9.30%

* November 17, 2008.

[i] Source: Morningstar Direct. S&P/TSX Canadian Dividend Aristocrats Index. One-year price return. In C$. As at December 31, 2018. The S&P/TSX Canadian Dividend Aristocrats Index is comprised of S&P Canada Broad Market Index constituents follow a managed-dividends policy of increasing dividends.

[ii] Source: Morningstar Direct. S&P/TSX Canadian Dividend Aristocrats Index. One-year total return includes reinvestment of dividends. In C$. As at December 31, 2018.

[iii] Source: Morningstar Direct. S&P/TSX Composite Index. One-year total return includes reinvestment of dividends. In C$. As at December 31, 2018. The S&P/TSX Composite Index is a market-capitalization-weighted index comprising the largest and most widely held stocks traded on the Toronto Stock Exchange.

[iv] Source: Bloomberg LP. As at December 31, 2017.

[v] Source: Bloomberg LP. Generac Canadian Government bond 10-year note index. As at December 31, 2017.

[vi] Source: Bloomberg LP. One-year price return in C$. As at December 31, 2018.

[vii] Source: Bloomberg LP. The average maturity of the holdings in iShares iBoxx $ High Yield Corporate Bond ETF is 5.44 years. As at December 31, 2018.

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