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Dividends Rule

(Dividend Rules)

Sustainable Income for Retirement plus
Protection of Capital and Capital Growth using Dividends

Ten+ years ago, was the first publication of this e-book in February of 2011. The good news is that here in 2021, the main tenant of "dividend growers" has maintained its value as we move into the late stages of one of the longest bull markets on record. This is truly the second publication of this e-book as I will:

1. Review the results of the last 10+ years.
2. What has changed and what has remained the same.
3. Do I still use this Dividends Rule approach today and if so has it been appended?
4. The expansion of this "Canadian equity" approach as it applies globally.

I will continue to keep the size of this e-book small…being concise matters. So, I hope you are not looking for a ton of supporting data to my thesis, multi-back testing on processes, and a myriad of charts…you will find only a sampling here. Why?
Dividends Rule, it is that simple.

My primary goal is to lay it out in very simple terms that are easy to comprehend.
My secondary goal is to help you warm up to and incorporate Canadian and Globally focused companies paying dividends as the basis of your Portfolio.

To this end my "Dividends Rule" thesis continues with a simple approach:

- **Dividends typically lead to portfolio growth along with sustainable income for retirement while protecting your capital, and**
- **Companies paying dividends typically also increase in value due to investor demand**

My thesis ties into my believe that,

> *"All investors are entitled to earn returns above their minimum needs, but they should only do so after they have maximized the certainty of achieving their minimum needs"*.

What has changed in 10+ years?

What began as a Canadian equity based approach around the "dividends rule" approach was enhanced at the end of 2012 to include a US and global mandate. This was further expanded in 2017 to also add additional criteria around stock price momentum, increased cashflow, and expansion of their earnings growth. I felt then and still do today, the 40+ year old investment modeling structure (Bonds and Equities) was overloaded with low yielding bonds. These bonds became more volatile and correlated to equities and was missing yield and growth found in Alternatives (Infrastructure, Utilities, Real Estate and Private equity). This view was further influenced by the global and alternative asset strategies by 2 of the best pension managers (Ontario Teachers' Pension Plan and our own Canadian Pension Plan) and the industry leading approach of the Yale Endowment. All of them have moved extensively away from bonds and into Alternatives.

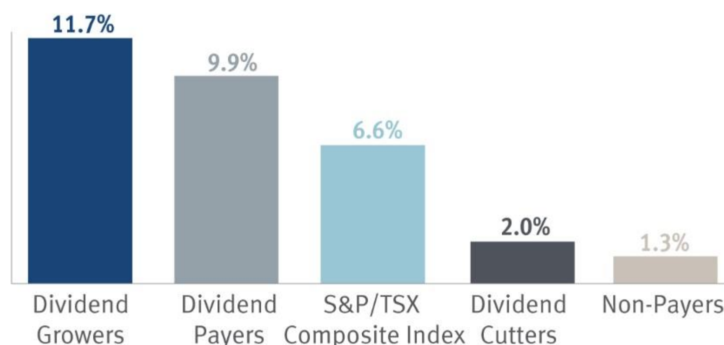
I thus began using the same "dividends rule" approach beyond our borders and into the Alternative category. The charts that follow will show not just a view on Canada, but also a US and World outlook.

Support is simple as well

Historically in Canada, dividends make up 30%+ of the total returns of investing in stocks depending on the period being reviewed. When we look at a 30-year period, thru 2016, of the S&P/TSX Composite Index, 33% of total market returns are from dividends.
(RBC Capital Markets Quantitative Research data as of Dec. 31st, 2016)

When you look at performance by dividend attribution, Chart "A" shows that Dividend Growers have provided 77% greater return than the index. The Dividend Payers group has provided 50% greater return than the index. And when compared to Non-Dividend Payers the performance is dramatically greater, to the tune of 9 times over that 30-year period.

Chart "A"

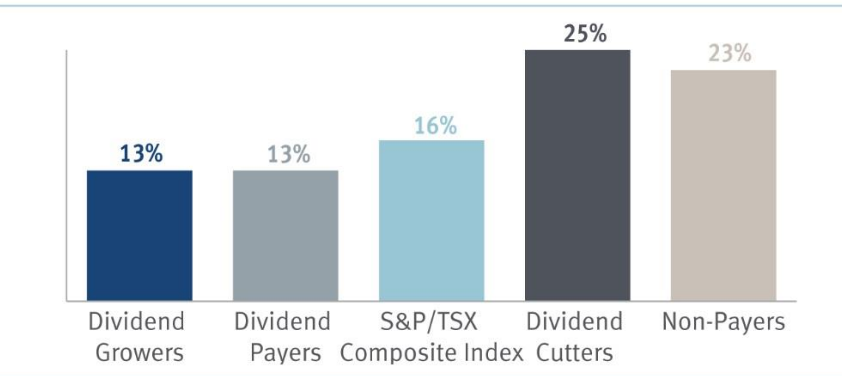


Source: RBC Capital Markets Quantitative Research. Data is calculated on an equal weighted basis, S&P/TSX Composite Total Return Index, December 1986 – December 2016.

From chart "A", if all you had focused on was companies who either grew their dividends or as a bare minimum kept them flat, you would have outperformed the TSX composite index. The data for this chart has only been accumulated since 1986, but I bet you would see this consistency throughout history.

Chart "B" shows that Dividend Growers and Dividend Payers have also helped provide stability and lower volatility through the continued market turbulence. This means less up-and-down when you hold these positions. Especially when compared to those companies who cut dividends or are Non-Payers. More on Dividend cutters when we get into the rules.

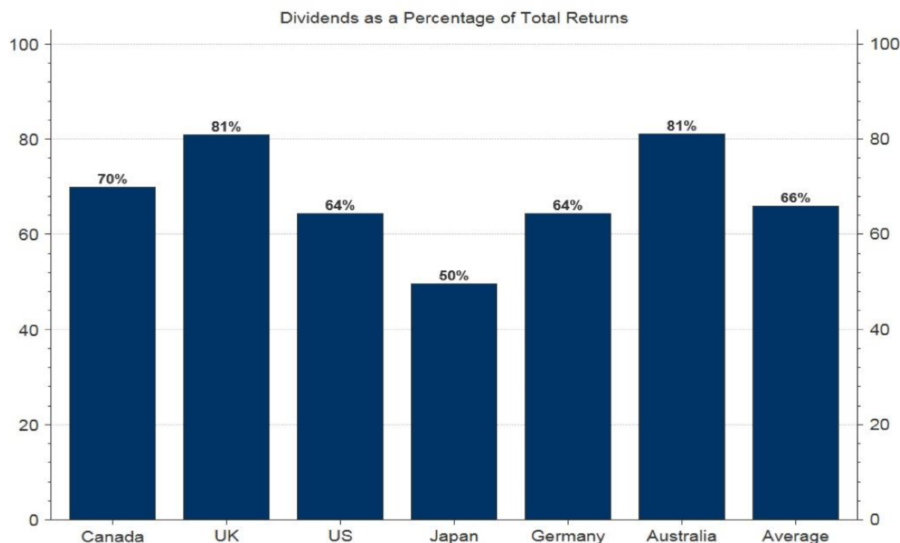
Chart "B"



Source: RBC Capital Markets Quantitative Research. Annualized volatility is calculated on an equal weighted basis, S&P/TSX Composite Total Return Index, December 1986 – December 2016. Standard deviation/annualized volatility is a commonly used measure of risk and is applied to the annual rate of return of an investment of measure the investment's volatility. A high standard deviation indicates a greater variability in investment performance.

Now let's expand our view to other developed countries around the globe. Dividends show similar value to one's total return. Chart "C", courtesy of Guardian Capital, shows dividends as a percentage of total returns. As can be seen, 50% to 81% returns are coming from Dividend payers globally. Thus, I apply the same "Dividends Rule" approach beyond our borders.

Chart "C"



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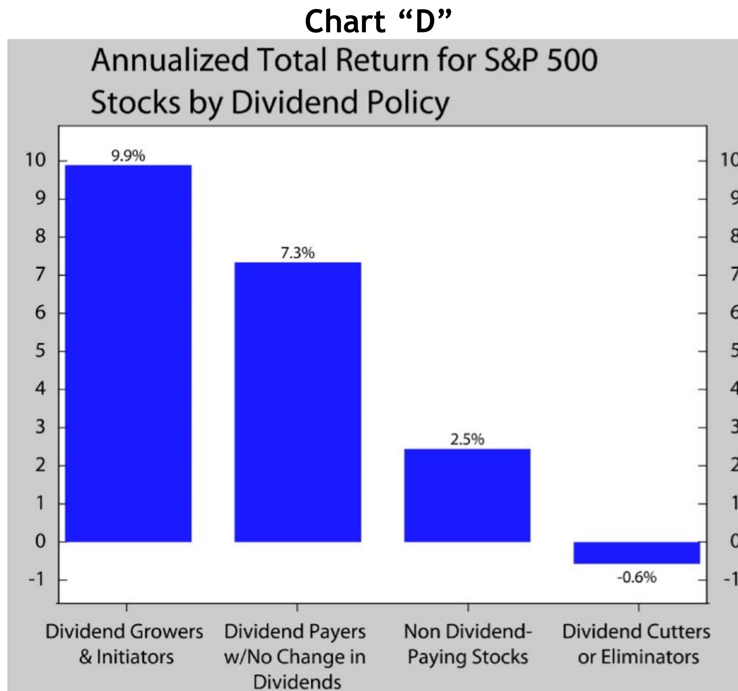
US equities have typically paid a lower dividend yield than what we are used to here in Canada. The S&P500 index is a well-diversified index that contains 500 companies, and in my view, is a far better indication of US performance than the constantly manipulated Dow Jones index most media outlets use. Chart "D" covers a longer period of time, containing 43+ years thru August 2016. The chart is not compared to the index itself, however when compared to Non Dividend Payers, the Dividend Growers & Initiators show a near 4 times return. So even in an equity market that typical produces less yield, the Dividend Growers are still the big winners.

Chart "D"



Source: Guardian Capital. All indices are equal weighted Geometric averages, January 01, 1972 – August 31, 2016.

Dividends also provide excellent inflation protection. When you look at the reporting period of 25 years thru March, 2014 for the S&P/TSX Composite Index it has shown dividend growth of 5.1% per year. When compared to 2.1% inflation growth annually, dividends have provided excellent protection to your purchasing power. That means not only additional growth above inflation (protection of your purchasing power) but also surplus to provide for income to live off of.

	Base March 31, 1989	March 31, 2014	Annualized Growth Rate
S&P/TSX Composite Index Dividend	$100	$344	5.1%
Canadian Consumer Price Index	$100	$170	2.1%

Source: RBC GAM, Bank of Canada. Index dividend was calculated using the following method: Index dividend = Index Total Return – Index Price Return.

Typically, we tend to look at risk as the loss of capital. When you think about risk one needs to account for the loss of purchasing power as well. Thus, protecting capital is about two things; protecting against loss of capital and loss of purchasing power.

Where are we at 10+ years later?

I still use dividends as the core in creating a diversified portfolio. I have added this overlay when choosing Global holdings and Alternatives. Again, Alternatives for me include Infrastructure, Utilities, Real Estate and Private equity. This way we are adding oligopolistic type businesses that have high barriers to entry with price protection to their services. Think of a toll road, cell towers, airports, power generation plants.

Dividend growth remains the largest categorized requirement and for example during 2019, of the 20 core positions I looked at in the dividend space that trade on Toronto's Stock Exchange, 16 had 1 dividend increase in 2019, 3 had 2 dividend increases in 2019. 95% had at least 1 dividend increase in 2019. This is a strong indication of corporate growth in both earnings and free cash flow.

The additional component on Canadian listed companies is my bias to those that have an emphasis on US and/or global markets and are not just subject to the Canadian consumer. I want to ensure greater diversification beyond our borders.

I continue to look for growth to further protect capital. We gain growth from an increase in the dividends as well as the company itself growing. So in the last 10+ years many aspects remained the same, however more criteria were added to the selection process. I expect changes to continue to be incorporated. However, Dividend growth remains the number one tenant.

My "sophisticated" name for the portfolio that focuses on both dividends and capital gains via a global outlook is the **Dividend Growth Portfolio** **(for those investing for their future).** When overlaying the need for income in retirement, this strategy can now meet these distributions and it is called a **Balanced Pensionlike Portfolio** **(for those in or nearing retirement).**

Dividend payers will increase their value

Driven by demographics the demand for yield goes unabated. Investors have placed an even greater emphasis on dividends as a greater percentage of our population moves into retirement. A third of our Canadian population is aging baby boomers who are either in retirement or thinking about it. They all need income from their investments to live on. They look to interest from bonds and dividends to provide their primary income. This is due to the majority of Canadians not having pension plans. During low interest rate environments like we are now in, causes many to refocus away from bonds to dividends. Further the number of income generating tools is frankly limited in Canada, placing increased demand on those available.
Thus the second component of my thesis, demand will drive prices up on these investments. This has been the same over the past 10+ years.

It will not only be the company's performance that will drive the value of their shares higher, it will also be increased demand. Many companies today, who do not pay a dividend, are beginning to consider adding dividends to their offering. One of the reasons this is being considered is to increase the value of their stock in the investor's eye.

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Before the kick off

A few ground rules. I believe that the **Dividend Growth** strategy should be at the core of your portfolio. For as much as I may seem infatuated with this segment, I would not suggest it is your entire strategy. Who you are and what you need and what you want, must be assessed. The risk required to sustain your financial plan and your palate for volatility, are critical to ensure a proper asset mix is structured. Thus you may hold some percentage of federal/provincial and corporate bonds and possibly preferred shares. Further other equity/bond segments for international exposure as well as strategic positions available through either direct ownership or through portfolio manager(s) should be reviewed. And as we end 2021, in the later stages of this long bull run, it is time for increased Cash exposure to entire your portfolio.

You Can Buy it all in Canada – Even the Global Exposure

My view on Canada, some 10+ years later, has changed over the past 3 years. It may be true that Canada has what the rest of the world wants, however the challenges have increased for these large foreign corporations as they are not adding to their Canadian footprint.

1. Access to globally based companies can be achieved through Canadian dollar investments through the Toronto Stock Exchange (there is not a requirement to buy in US$)
2. Regional political positions remain diversified across Canada
3. Federal policy is dictated by non-majority party structures in Canada and does not provide longer term views for corporations wishing to invest here
4. We still have the natural resources the world needs and wants, however their access is continually challenged

If you wish to read an excellent book to give you pages and pages of facts to support why we are a great country to invest in, I suggest picking up **"Shell Shocked"** by John Stephenson.

The piece we are going to focus on to keep this book concise shall be my darlings, my favourites, the Canadian listed companies providing the Dividends for both income and growth that provide our Canadian, United States and Global exposure.

"Dividend Mojo"

The "mojo" of dividends, or let's call it the "Rules" of this **Dividend Growth Portfolio** is as follows:

1. We like it when a company raises its dividends, we like it a lot
2. At the same time, dividends can be flat for 5 years as well, that is okay too
3. We run away when you cut dividends and will not come back until you show us 3 - 5 years of stable dividends and we better see them being increased as well
    a. I'll talk about Manulife later – the big slap in the face
4. We get all google eyed when you tell us you are going to buy back shares
5. No one company should be more than 5% of our core strategy except when they act like a diversified conglomerate
    a. I'll talk about Brookfield Infrastructure Partnership later
6. We will honour the rules we establish and will commit them to writing
7. We will be diversified
8. Remember that capital gains on our positions is a good thing
    a. so yes this means paying some taxes, remember you made money and that is a good thing
9. Make sure dividends are not greater than their cash flow…recipe for disaster
10. Growth by acquisition is good but do it with cash, debt or cash flow please, not by selling more stock
    a. But not too much debt
    b. Issue bonds, but not so many as to put our dividends at risk

That sure seems like enough rules to me, in fact the top 5 are at the top for a reason, they are 90% of the "mojo" we need to make this work and work well. So prepare to drink the Kool-Aid and if you are in agreement with the top 5, I suggest stop reading there, I will not be offended.

Flat is okay but bigger is better

(Mojo rule 1 and 2)

Incorporating component 1 and 2 of our "mojo" starts to thin the herd very quickly. Of the approximate 1,936 stocks traded on the Toronto Stock Exchange (TSX) 348 pay a dividend as of November 14th, 2021.

When we add the additional requirement "to have grown their dividend quarterly year over year" the list is reduced to 138 companies. This compares to only 79 as of March 15th, 2010. Most of this increase has come from new dividend growers and newly dividend paying companies. That is great news. Sure cuts down on the companies we need to consider and to monitor.

Removing 93% of stocks on the TSX, sure makes my job easier when setting up a dividend growth portfolio for clients. When applying my other screens, it brings the list to 32 companies. Now I have a more manageable group of companies to consider to be incorporated. This helps us to become more focused and directed in our portfolio. One of the biggest issues I often see when looking at clients' portfolios is no rhyme or reason for the holdings? Just because there are over 5,000 mutual funds available in Canada, does not mean one should follow them all or own them all. Just because there is an index for pretty much anything, does not mean one should own all the indexes. Thin out the options and apply a set of rules to make it much easier to manage.

Back in February 2011, I recommended 28 companies for the **Dividend Growth Portfolio** (range is typically 20 to 30). Starting 2021 off, there are 20 TSX listed companies versus the 348 possible dividend payers. This makes daily, weekly, monthly management easier and more effective. A lot has been written about diversification, however at about 20+ holdings, you start to hit a saturation point of effectiveness of diversification. There is no need to hold all 348 dividend paying companies to achieve effective diversification. We will discuss this in more detail later.

So why do we want to see dividends being either flat or growing? Simply, it helps to tell us that management is able to either maintain their business operations or are growing their profits.

Companies rarely increase their dividends without having the cash flow to sustain this increase or the opportunity of growth in their businesses. Thus by telling your shareholders that we are increasing how much we are going to pay out, the company is giving you a proxy of how good their business is not just doing today but also for the next 3 to 5 years. It tells us, we should stick around, as management is doing something right to support our belief in them and the company.

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So why would we pick a company whose dividends have flat lined?

(Mojo rule 2)

We have all experienced one of the most dramatic financial and economic occurrences of our lifetime starting in 2007, and like you, companies had to re-trench. They had to dig in, buckle down to grow and survive. And they had to do this all over again in 2020 due to the Covid-19 virus. So, if they managed to come through these times without cutting dividends it tells us they are good at what they do. It also tells us, they respect their shareholders and the reasons why many own them; for the dividends. Some companies have propped up their ability to pay dividends to avoid cutting them by distributing more than they are making. As we endr 2021 one needs only to look at their cash flow to tell us if it was and is sustainable. For by now, they, we should now if they can survive and thrive.

For surviving and getting ready to thrive going forward, I reward them with the knowledge that I will buy their company and their management. These dividends during 2008 and 2009 and 2020 and 2021 helped “pay me to wait” for them to recover. More on “Pay me to wait” later.

Another reason to consider a flat lining dividend is the war chest they may be amassing. One thing about dividend paying companies, they tend to be more mature and some even say boring. I do not know what is boring about getting rewarded every year with dividends, but that is me. These companies cannot always grow organically so they often buy others. They may have been putting aside cash for an opportunity to buy a competitor or advance their position into a new arena. This deployment of cash could lead to increased dividends and share value; both being good.

The case for Rogers

(Mojo rule 1)

I believe we lost a great Canadian business person when Ted Rogers passed away. He took a company that had been a net debtor for most of its existence into becoming a cash generating machine. Ted built Rogers on debt and smart timely acquisitions and it made the dividend hit parade in 2007. Ted bought his head office from Confederation Life when they blew up, Bought the Skydome for $25 million (4% of its cost), oh yeah he already had the main tenant, the Blue Jays to go into it. One of his greatest traits that I admire is that he was opportunistic. This is the one skill that many an investor needs to capitulate on. It is one thing I like to pride myself on in picking positions to add and when we choose to add them. You will see the word “opportunity” appear a number of times throughout this book. I believe one needs to be opportunistic. Not a market timer, not a bottom feeder, etc. but opportunistic like Ted. One of his remaining legacies was positioning his company for future growth and sustainability when he would be out of the picture. Rogers joined the dividend patrol with earnest in 2007 and has seen its dividends grow by 400% since then. *
When we need to add telecommunications to our portfolio, BCE may be a great one, but don’t forget Rogers.

* As per Rogers dividend history, 2007 quarterly dividends were $0.125, and in 2021 they have risen to $0.50 quarterly

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Once stabbed in the back, we bleed, for a long time, or…
Oh Manulife how we used to covet thee…and we do once again

(Mojo rule 3)

If you cut your dividends you just broke mojo rule #3 as you forgot the basic of all rules; we owned you partly because of your dividends. And oh did Manulife do this to us in 2 ways. They not only cut our dividends in half in 2009, they also sold equity to add cash to their balance sheet. So we took a 50% haircut on our dividend income and that really hurt. They further depleted our ownership percentage when they sold $2.28BB in 2008 and $2.5BBin 2009 in new equity. They stabbed us once to stop us from running, and again just to make sure we would not leave.

Back in the 2011 version of this ebook I said;
“Well, as much as many folks say to me it is time to buy Manulife due to its much lower stock price, I will not add it yet. When you reduce your payout by 50% and cut my ownership position by selling more equity, it should be trading at half value. And sorry, until they show me solid dividend numbers for 3 to 5 years, I will not be stepping back into ownership.”

In the summer of 2014 Manulife began increasing their dividend after paying a flat dividend for 5 years. When this happened I started screening them for consideration, but they did not bump off a better consideration until March 4th, 2016 when they were trading at $18 to $19/share. So here we are November 14th, 2021 and Manulife is still on my buy list @ $24.98 and has had a dividend increase every year since 2017. Patience is a requirement when looking at companies. So even after getting bumped off the list, they worked their way back on. But, do it to me again, and you shall be sold Manulife.

Back in 2009, I did own Manulife but in a different way. When they issued a bond in July, 2009 with a coupon paying 7.4% annually, I added it to a number of my client’s portfolios. Why? I still like their business and with the dividend cut it helped them dramatically in meeting their debt obligations. So I bought their debt instead as they have to pay me before the equity holders. We were rewarded with a great annual yield of 7.4% and the bond immediately traded up and was trading 16% over par as of 2010-06-30.

The folks at Manulife cannot be too mad at me, for I supported their bond back in 2009 when they needed money and they are on my buy list in 2021. Peace…

So if you stab us in the back, we shall sell you and go elsewhere as there are others who pay well and have good opportunity for growth. Do not think that you have nowhere to go. And don’t get hung up on lost value. If you do, you are forgetting why you invested, why you bought that company in the first place. It was for income, dividends, and capital gain, not emotional support. You have to leave that “but if I sell now, I lose 50% of my holdings” behind. Yes, I know it is true, but if you are properly diversified that 50% loss should only be a 2.5% loss to your **Dividend Growth Portfolio**. We can now move that 2.5% over to another dividend opportunity that will grow. For I bet, that 50% loss you dwell on could stay that way for years and not pay you for the privilege when we could have moved on to the next one. And that next one pays us well and will increase in value.

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Buy more of yourself please

(Mojo rule 4)

So the dividend is flat but the company keeps buying more of itself every year and the stock goes up in value. What a great concept! We believe in the company, that is why we own it. Management believes as well so they buy their own stock and buy it every year. So why is this great for us?

Simply; reduced shares mean more cash for us. Every time they buy shares of their company in the open market place they make us more money. Two ways; One, they reduce the number of shares outstanding and thus the company's equity to share ratio goes up, and typically this transcends itself into capital gain. Two, they have to pay fewer share owners dividends, and that helps cash flow. There is nothing like having management with more skin in the game. The company believes in themselves and management buys into the concept and has the free cash flow that they would rather pour back into their company than buy something else.

This is another great reward of a good company paying dividends. What often gets missed when the yearend or quarterly numbers are given is the share buyback that the company is proposing to execute. I like this one especially for the capital gain it provides us. It is a very simple way for growth to occur in our portfolio.

Let's look to the great prognosticator from Omaha, Warren Buffett. In his letter to shareholders for 2010 about 2009 results, he talks about how:

> *Berkshire Hathaway acquired GEICO in two stages. In 1976-80 we bought about one-third of the company's stock for $47 million. Over the years, large repurchases by the company of its own shares caused our position to grow to about 50% without our having bought any more shares. Then, on January 2, 1996, we acquired the remaining 50% of GEICO for $2.3 billion in cash, about 50 times the cost of our original purchase.*
>
> *(page 6, letter to shareholders, http://www.berkshirehathaway.com/letters/2009ltr.pdf)*

Buffet and Munger saw their holdings grow from 33% of the Company's equity to 50% over 20 years simply from GEICO re-buying its shares. Without buying any more GEICO shares they saw a 52% increase in their ownership position. This is the power of share buybacks and why I like this strategy. For Berkshire Hathaway they grew their $47MM investment to equal $2.3BB and a good portion of that due to buybacks. Now could you have done what Warren and Munger did and buy the remaining 50% of GEICO for $2.3BB? They still saw a great company with growth and value and pulled the trigger and now own it all.

Rules are not meant to be broken

(Mojo Rule 5)

This one is going to be a tough one for many of you. **Create the plan and stick to it**. I believe this is the most important ingredient that I bring to the party as an advisor. **Helping you create a plan and sticking to it**. Emotion is your weakness, I simply do not get attached to holding a particular company. "I'll wait for it to come back", is probably the most over used phrase in the investment world. You will see suggestions on how to handle this throughout the book.

No one position should be more than 5% of the **Dividend Growth Portfolio** unless it is broad sector ETF (Exchange Traded Fund)/ Mutual Fund or a stock that is truly broad or global (like Brookfield Infrastructure Partnership -BIP.UN). I would suggest that holding a bank stock or an insurance company stock falls into the 5% maximum. Broad sector exposure, such as to a globally diversified holdings of infrastructure via BIP.UN, or to US dividend payers via a currency hedged ETF allows for a position to be more than 5%. Why? BIP.UN has exposure to infrastructure that is diverse and global or US listed dividend payers that are part of the S&P500 and are not based on just one company and gain diversification due to many holdings within the ETF.

However, the first question I usually get, since it is a rule is, "How far will you take a position to before you consider the rule broken"? Why do we always go for the rule breaker first? Like mom saying, "don't touch" as she eyes you wondering about that hot pot on the stove. So what do we do when she is not looking, we just have to touch to find out why the rule is there. We have to learn by our mistakes.

So on this topic, how many have made a mistake in the equity market and held onto a position too long, long after the profit has disappeared? I still see zero value beside the Nortel shares in client's portfolio's when transferred over for me to manage. We all have done it. We break rules that we ourselves established.

The 5% represents an opening position on a company and if the other 19 positions we add at the same percentage all go up in unison, well we would never break away from that 5% weighting. We know this is not going to happen, some will go up, others stay flat, some even go down. We will wind up with holdings above this 5% threshold. I have an easy way to hold to this rule. **Rebalancing**. At least once a year, we need to consider rebalancing our portfolio and this gives us time to be overweight for a period of time. So the rule that follows our 5% maximum weighting kicks in called "rebalancing" that gets us back on track. If we get to say 7% weighting in a position due to its run up, we trim back and take some profits. We can now redeploy to other areas of the portfolio with a new position or adding to existing.

What about when a position goes the other way and goes below its desired allocation? It is starting to create a capital loss. It is pretty hard to keep all at 5% with market volatility and performance of holdings. One thing we do know is a company's value will trade up and down. The key here, do we still like the story behind this position? Drifting lower by 10% can and does happen to the best of companies. The concern is when we see 15% and 20% losses on positions. What then?

(see below on stop losses)

We also need to think of times to sell when we are in a loss position to either move elsewhere with our money or protect our money. Imagine if you had this discipline during 2008 and your Royal Bank shares started drifting off of its highs of $51 on its way to $28? As much as you believed in its ability to come back, you had to make a fundamental decision. Do I sell when it was off 20% or hold for the long term? Discipline says we would have gotten out of it before it lost 45%+ of its value. This is one of the toughest ones to take the emotion out of the decision, and where I feel our process will save us.

Stop Losses

To reinforce this approach, stop losses are one of the simplest and truly excellent tools that exist today. The ability to set a floor to the loss you will permit the day you buy the stock. You can attach it by a set dollar amount or it can track with the stocks move upwards, so that it is triggered upon retracement. I find even the best company can trade off 10% for what appears to be no reason especially with the volatility in the markets of today. I believe15% is a good starting point for stop loss consideration, but you have to find and determine what works for you.

Further a stop loss works well only when there is liquidity. Placing a stop loss on a stock that trades a few thousand shares a day can cause you to get "stopped out" when the stock was not really tracking that far down. Stop losses work best with high daily traded volume companies. Else, you have to employ the truly hard to enforce stop loss: the mental stop loss. You know, the one you swear you will use yet when the stock hits that price you bow to the other side of your brain and say, "It is still a good company, my stop loss is now a $1 lower". Enforcement of the mental stop loss is a hard one.

The fundamentals may not have changed in why we owned Royal Bank in the first place, but market forces can move even the best of companies in the wrong direction. I believe you cannot ignore the market. For it not only goes against us, it can go with us too. It also creates opportunities as well. Would you have thought of buying back into Royal Bank at $28 in March of 2009 with a dividend yield of 7.14%? Opportunity at that time was massive. And the opportunity for dividend growth as well. The quarterly dividend in 2009 was $0.50, and was raised 13 times thru 2017 to $0.91. This represents a further 82% growth in dividends you would be receiving…Wow!

Why go any further with our discussion?

As I said earlier, these are the five key components to keep our approach simple, so why add more pages to this discussion? Frankly for many of you, this is just too simple. So for you, I shall add some more thoughts and data. For the rest who feel comfortable, you can stop here and start evaluating if this is right for you. Start deciding if the **Dividend Growth Portfolio** approach should form the base of your portfolio.

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Review and Rebalance

(Mojo rule 6)

This one is defined as part of your Investment Plan, to be discussed shortly.

One common error seen far too often is avoidance of a rebalancing strategy. For most it is employed annually or semi-annually. The idea is to avoid drifting away from the basis of the rules that we are not to break as discussed earlier. Incorporate a process to trigger automatic rebalancing within your portfolio to the asset mix agreed to. This does not mean ignoring the market until the quarter comes to a close. Adjustments need to be considered between re-balancing time frames due to market circumstances. One valuable lesson learned in 2008 & 2009 is that ignoring your portfolio is extremely dangerous. Someone, you or your advisor, has to maintain an outlook to actively managing your portfolio. With today's volatility we have to stay active. Buy and hold is a very dangerous game without oversight.

Keep you and I on track

(Mojo rule 6)

Why do I create an Investment Plan for clients and ask them to stick to it? This one is due to human nature kicking in. Without written rules, we will break them and justify it endlessly. So the Investment Plan serves to force a set of rules on to you and on to your advisor. We just seem to need Mom's wooden spoon (or was it a spatula) at the ready to keep our actions on track.

What the Investment Plan should contain are the following key elements.
There are others but these make up the core:

1. Risk profile
2. Return Objectives and Expectations
3. Cashflow needs
4. Investment Strategies
5. Asset mix
6. Tax Considerations
7. Service Plan
8. Fees

These 8 components should form the basis of a very simple document, 3 to 5 pages at most, that provide us the rules by which we will operate. If it takes 20 pages to convey your Investment Plan it will be far too big for us to follow, let alone pull out 12 months later to figure out. I will go with my motto of simplicity, and if you cannot state it concisely in 20 pages, you better try for 3.

Diversification

(Mojo rule 7)

We all need an inflation hedge. The risk of staying in GIC's is the loss of purchasing power. After all, that is what cash is, purchasing power. The risk of moving investments away from cash is some loss of capital. Balancing the risk is critical. Inflation risk is the one that often gets forgotten. Dividend paying stocks assist us with both issues. They provide us income while growing in value and increasing our purchasing power. Think of dividend payers as your hedge on inflation. This helps increase the duration your capital can sustain you.

Profit or Taxes, which one rules the roost

(Mojo rule 7 & 8)

I have seen this one a few too many times as well. Over allocation to a great company has happened over time as dividends and splits have occurred. All of a sudden 50% of your portfolio is wrapped up in 1 or 2 positions. Now the tax trap enters our mind. You have made a ton of money on that position and get trapped in the cycle of not wanting to sell and diversify, even though you know you should. All because you made money? No, because you have taxes to pay.

Wasn't making money one of the reasons you bought that position in the first place! Why is it that we never hear someone gloating about how much they lost at the casino, only what they won? Yet the casinos seem to stay in business with all these winners out there! So you made some money! Part of that obligation is paying taxes on it. There may be strategies you wish to employ to reduce that tax or spread it out over a number of years. But do not forget that diversification is an important part of your portfolio's requirement. Without it you will be breaking many rules. Over allocation will put your risk profile out of whack. More risk than you wish, want and demand. Find a solution to resolve this over allocation and spread out your risk.

A debt to pay a debt

(Mojo rule 9)

We have seen during the meltdown of the 2008 markets and the economies of the world, especially in the US, debt to pay debt. As we end 2021 the horizon appears to be filled with the same issues here in Canada amongst consumers. Additionally, the continued issue of debt by all levels of government around the globe is much the same approach, debt to pay debt and could lead to the next major crisis we endure. I had the pleasure of hearing Meredith Whitney at Sprott's 2009 event ***"An evening with the Bears"***. During which she spoke about the next wave of mess coming from consumer credit card debt. She expounded on how many Americans were using credit card A to pay the interest payment on credit card B, and credit card C to pay credit cards D monthly payment. And so on, month after month. Debt paying for debt is a dangerous cycle indeed.

Well the same goes for companies that meet their obligations of dividends or monthly distributions with debt on the firm's capital. Your distributions should never exceed cash flow. Once a company makes it known that they will enter into this ever spiraling method, it is time to leave that position behind. For the fundamentals of their business can no longer support the dividends. At this point there is only one prudent move and that is to sell out and move on. There are other opportunities that we can add as replacement, so no need to hang on to this baggage.

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Grow

(Mojo rule 10)

Acquisitions are a normal part of business and often the only solution for a company who has a very mature business. For us, I want to see this done by using the cash war chest that they have built up over many years of sound management and profitability. That is my favorite.

Next up is debt, and typically in the form of bonds or preferred shares. Not likely to see convertible debentures here as we are dealing with more mature businesses. Most of the truly sound businesses carry some form of manageable debt this way. We see fabulous numbers put up constantly from our Canadian banks in both profit and dividends, and they all carry debt on their books. The key is not an overwhelming amount of debt. We want to ensure that as they add these preferential debt holders they can easily make these payments as well as our non-secured dividends. After all, we want our dividends to continue and grow.

Don't dilute my Mojito

(Mojo rule 10)

Taking the rum out of a mojito, just ain't a mojito. If you are going to have the drink, have the drink. So when Manulife issued more stock to raise their capital position to help meet industry guidelines it was further dilution to shareholders value.

So what about a company who goes about issuing equity to fuel acquisitions? As much as those acquisitions may help sustain future dividends, they thin out my returns today. One has to figure out why you bought this company in the first place. One of them was to pay me either flat or growing dividends. Issuing capital tends to break this rule. We need to be clear that the acquisition will actually facilitate an increased dividend in the future to stay with this name in our portfolio.

We should also ensure the payback is not longer than expected. Otherwise we may be faced with a reduced dividend and/or reduced growth expectations. My counter move, perhaps cowardly, is to run. I will sell out and find a better replacement. Who knows maybe 5 years out, we might even step back into ownership, but for now we can go elsewhere. Much like what I did with the aforementioned Manulife when it showed back up in 2016.

Other Considerations
These are not directly part of the Dividend Rules above, however I feel they provide additional value for your consideration.

Tax efficiency

(This part applies to those having non-registered investments)
Those who hold bonds, and bonds only, do so typically out of fear of equities and having been burnt once before. There is not an investor who has not lost money on an equity holding. Until 2008, many thought that you could not lose money on bonds, until they woke up to see them trade down along with the collapse. In fact, many clients, including me took advantage of this and bought high yield debt in January of 2009 to ride the roller coaster spread to the bottom. That meant we would make money on bonds as they trade back into normal ranges.

The beauty of any form of income is what you get to keep not what you think you get. No one brags about the after tax income they make, it is the pre-tax number we love, because it is bigger. We are just wired that way. However, you need to cross the wires and look at the after tax income on all your investments, especially the majority of us who now need income from these investments.

In many cases, dividends can be worth 1.4 times more than a bond interest payment due to tax efficiency. I am sure you know this from filing out your annual tax forms! Well if you don't, it is an important fact to understand about your tax situation. The simple two part question to ask those preparing your taxes is, "If I make one more dollar of interest, how much do I get to keep?" And, "If I earned one more dollar of dividends, what would I get to keep?"

Odds are, $1 in dividends is going to give you more money after taxes. Now this is based on one assumption, that is you have investments outside of a RSP or RIF/LIF. If all your income comes from these registered tools, it does not matter, as you are taxed at the highest tax rate anyway. If you have unregistered assets, this is where the impact comes from.

On this note, please tell me you are using Tax Free Saving Accounts (TFSA)? This is where the government has done us a big favour. For everything you earn from investments held in this account is completely tax free. **Again, tax free**. You got the free part, right? I shall spend no more time on TFSA's, other than to say two things. Get one started for both you and your spouse. And secondly do not just hold saving accounts in your TFSA. Investments in a TFSA can be anything like what you can hold in a RSP, so that means stocks, bonds, mutual funds, GIC's, etc.

So you have moved what you can into your TFSA's and still have a bunch left over in non-registered investments. This is where the dividends should be held. Hold your appropriate asset mix of fixed income instruments in your registered holdings, and the dividend and capital gain opportunities in your non-registered holdings. That is as simple as it gets. There is great after tax impact in dividends. So much so that some can get their income tested benefits back and even reduce or eliminate the claw backs on Old Age Security.

When to DRIP

I will say this outright, not a big fan of DRIP's, or Dividend Re-Investment Plans. And it is for only one reason, balance or what turns into lack of balance. This discussion is more about Rebalancing than DRIP's. Many companies no longer offer these anymore as well.

I have seen a few accounts that have gotten way over exposed to a position by reinvested dividends. A DRIP is typically done when you do not need the dividend for income, so you take advantage of the dividend automatically buying more of that company's common equity. What often happens is you have forgotten your asset mix and allocation maximums and are now overweight in one company. A DRIP can easily allow this to happen even over as little as 5 years, especially with a good company.

I prefer the dividends to come out as cash as it gives us power and opportunity. Opportunity to use that cash as is required. Say for income needs, but also to move that money to positions that need to be increased to bring them in line with our guidelines or to add new positions. We have the ability to use those powerful dividends as desired and needed.

As many experts may agree with me on this, many will disagree. All I am asking is to be aware of the future implications of your decisions and watch you do not get over allocated to a position.

Legging in, legging out

I have seen the trap here too many times. You have an overloaded position in US dollars or 70% of your portfolio in one or two bank stocks. You cannot pull the trigger to make changes because you get paralyzed by the sheer opportunity to screw it up.

Use a plan of legging out or legging into a position to remove the paralysis. I think the line is, "more bad decisions are made by not actually making them". To remove the paralysis we develop a structure by which we will enter or exit a position. We go into this knowing full well that we may make a bit or lose a bit in the short term. In the long term, we have achieved the desired result.

How long this process is, I cannot say, for each situation has its own requirements. I will say this, when taking on a new position; I typically like to add a ¼ to a ½ on the outset so that we are in. We then monitor the market reaction around our position and add to it in stages over the next weeks to a month. If we have made a decision to add a full position of "X", then we want this in our portfolio. Sometimes, the market may move dramatically up in a few weeks, say "X" is now worth 10% more than it was 2 weeks ago, and the value side of us says we will wait for it to correct. By having a legging in strategy, we would have purchased 3 to 5 days after our initial allocation with another ¼ or ½ . Why? We want to own this position and have committed to adding it to our portfolio. The fundamentals of why we wanted to own it are still in place.

On the other hand the market could move down 10% in two weeks and we will watch for it to bottom and buy on its first daily up tick. Some may call this market timing, I call it opportunity. We like the company, the market just made it more affordable to own. On the other hand if the market moves 15% or more (say to our stop loss position), we have lost an incremental amount, as we were legging in. We then have to re-evaluate if we still like and want to own this company, and buy at another time, or hold off for a while.

We are not making "all in" bets today. I find clients find comfort in it as well. It makes our decision process defined and staged. And again, our "all in" bet if you wish to call it that, is to no more than 5% of this portion of our portfolio. So again, we are reducing our risk and controlling our decisions better.

Pay Me to Wait

I am not sure who coined the phrase "Pay Me to Wait", but it surely applies to dividends. If I like a company, and they are in a strong financial position, and they have opportunity to grow, but the market is not reflecting this value today, dividends offer me a chance to ride. They give me the ability to wait, ride it out, until the rest of the investors start piling into the realization that this company is really good. On top of that I get to use this income the way I want to until the capital gain hits the books. I get to buy more of them, buy others who may be in the same position; I gain flexibility in this patience.

What Does it Take

I typically say that you need to have at least $100,000 of investable assets to create a decent mix. Any less and it is hard to complete the allocations especially with legging in and out. Sometimes an ETF or Mutual Fund may assist to cover a basket to make it accomplishable with less, but you have to limit your choices here as you can become the index which we typically do not want to be. Many ETF's own a large number of positions so you wind up being the index without realizing it.

3 Years of Cash – are you nuts?

There is an un-common rule out there that suggests one should keep 3 years' worth of cash withdrawals in cash at all times when you are in retirement. The more common rule is to hold 1 year of cash. You then keep the rest invested. This way you do not have to touch the rest to pay those persistent monthly withdrawals.

Back in 2011, my first version of this e-book, I was not heavily in favour of the expanded approach. That is having 3 years of cash on hand. As I have continued to learn and grow my understandings of my clients who are in retirement, I have found many are fond of this approach. In fact, I have many clients who hold at minimum 2 years of cash for withdrawals.

Why are retiree's fond of this approach, hoarding some cash? I feel it is about security. The wealthier my clients are, the more they worry about having enough to meet their live long needs. Having 2 to 3 years of cash on hand allows them to not be forced to sell during corrections. It further provides the opportunity to even enter some shorter term buys as the market corrects, thus taking advantage of this cash. Additional, flexibility is gained in not having to sell a position each month to meet cashflow, as that sale might have to be done during a downturn.

Put the Bow on it

I believe I have given you enough compelling evidence, suggestions, methodology and rules so that "dividends can truly lead to sustainable income and portfolio growth". Dividends have so many attributes. Protection of your purchasing power required to carry you through retirement. Dividends are truly the way to get returns on equity holdings and with less volatility. Tax efficient distributions make them even more powerful than interest baring tools. I believe, they should be at the core to any portfolio.

I also believe I have put some thoughts in your mind as to how important these strategies are and that if you cannot do it on your own, find the right professional to assist you. There are many critical elements shown here that you or your advisor must follow through on. I urge you to seek out the best advice you can to get the plan developed. I further suggest you ensure that all of the components reviewed are part of your overall program. If you are not getting the best and right advise, find the right person to help you. You deserve the best professional assistance available.

All the best…

Vaughn Warrington / CFP®, FMA
Investment Advisor

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