Power of Dividends

Investing in global dividend-paying businesses

The power, consistency and predictability of dividends

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No such thing as a sure thing... or is there?

Investment fads come and go, and investors are the ones who usually pay the price. Afterward, the investor vows never to get caught up in the euphoria of an investment fad again. The problem is, most investors have short memories and the enticement of "a sure thing" weighs heavily on investors' shoulders.

The old adage, "If it sounds too good to be true, it probably is," is something that investors should heed. Markets move in cycles and are often driven by fear and greed. This makes it difficult to predict the direction the market will move at any given time. In investing, there is no such thing as a sure thing – well maybe there is.

The importance of dividends

John D. Rockefeller, the American industrialist and philanthropist, once said "Do you know the only thing that gives me pleasure? It's to see my dividends coming in." Although this quote is more than 100 years old, many investors today are becoming increasingly attracted to dividend-paying stocks. This desire and interest for exposure to the asset class of dividend stock paying companies is the result of extremely compelling reasoning.

Attributes of a dividend-paying company

1. Inevitable businesses

"A market is never saturated with a good product." – Henry Ford

Companies that have a long track record of paying dividends tend to be businesses that provide a product or service that people continually consume. Moreover, they also have a strong brand, which is represented by customer loyalty and repeat business. These factors often translate into higher profit margins which correspond with strong cash flow and earnings growth.

When the performance of dividend-paying stocks is compared to non-dividend-paying stocks, the attractiveness of dividends becomes even more apparent.

In the chart below, you will see how the MSCI Total Return Country Index compared against the Dow Jones Dividend Index. From December 1998 until September 2006, in every major developed market, dividend-paying stocks outperformed.

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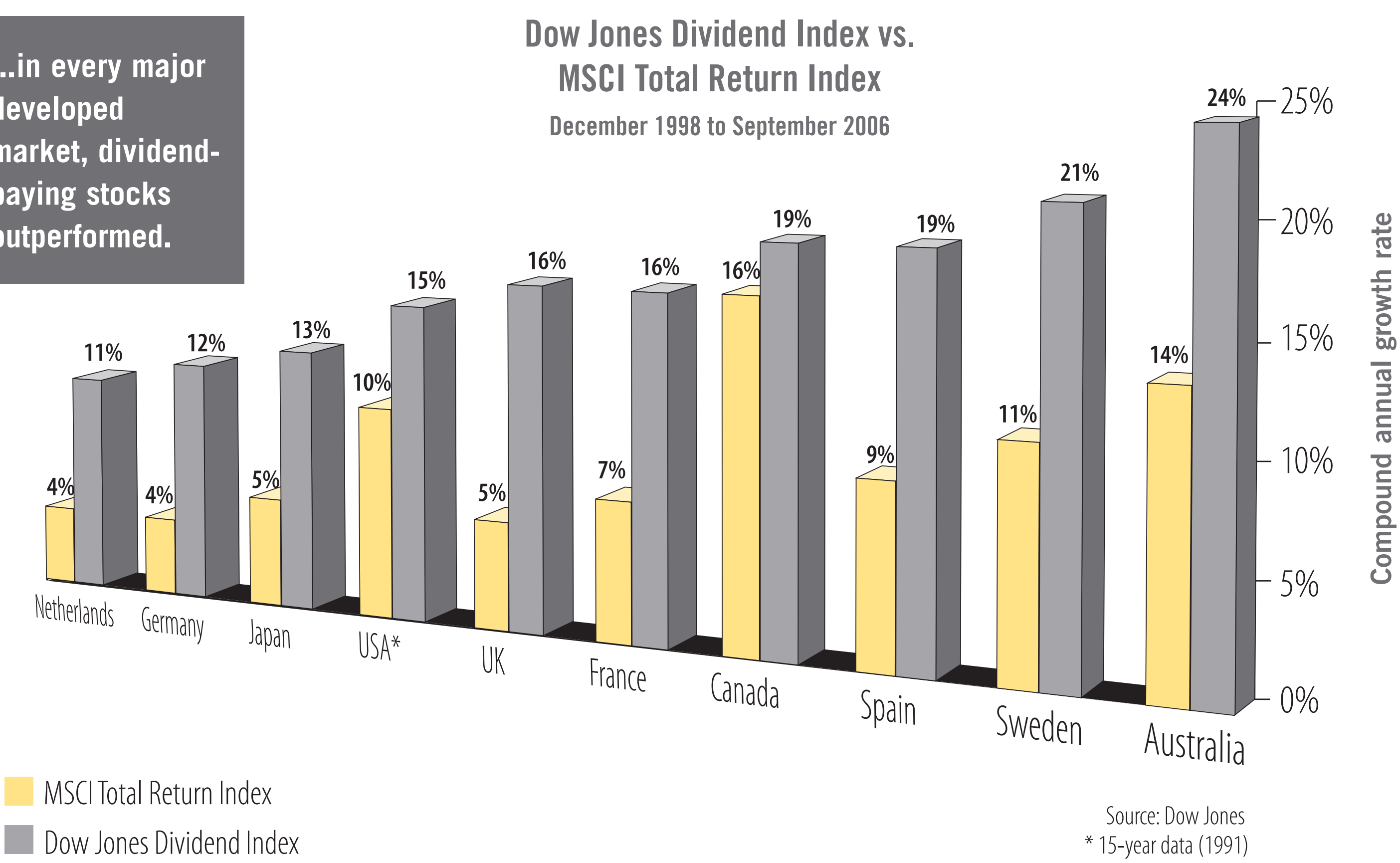
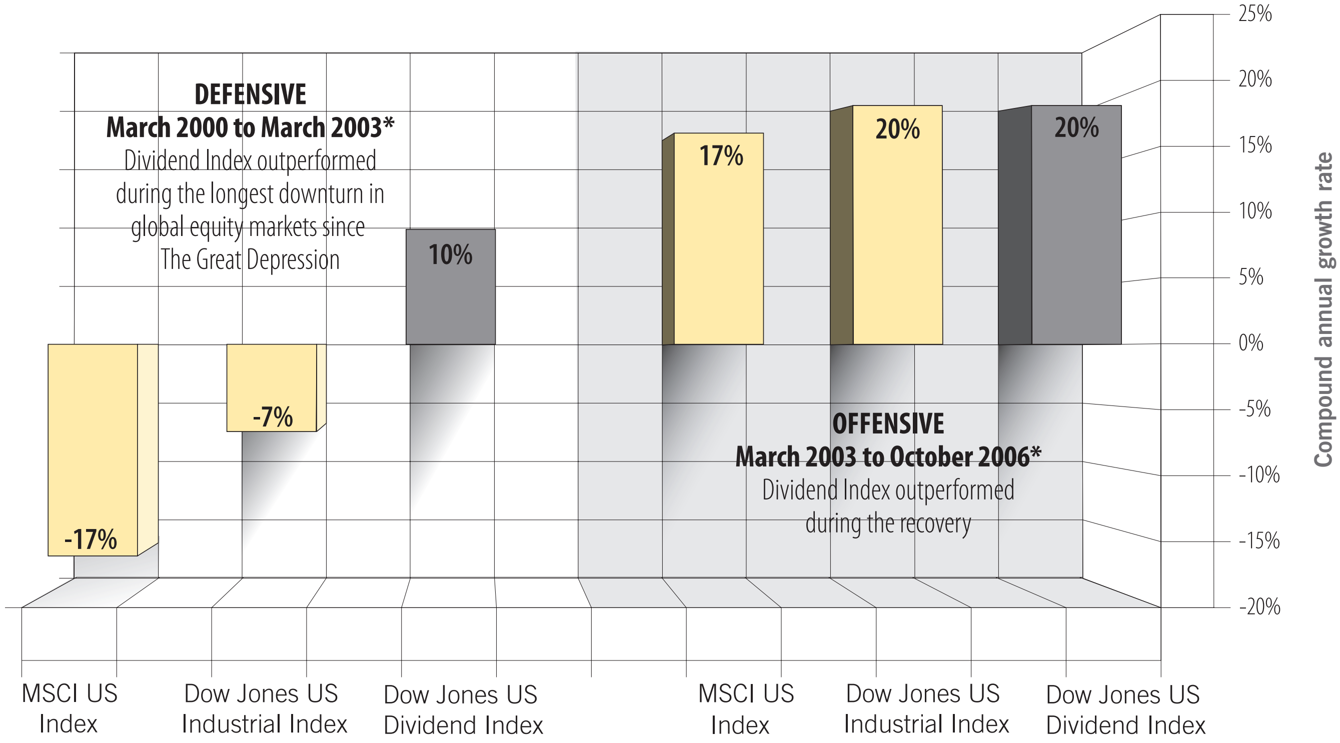


Source: Dow Jones
* 15-year data (1991)

Dividends are both defensive and offensive



*Source: Dow Jones $US returns

2. Good corporate governance

"Public business should be conducted publicly" – Chinese Proverb

Premium dividend companies generally provide better corporate governance. Once a company implements a dividend paying policy it is unlikely to dispense with it. Since dividend payments are required to be included with cash flow and earnings statements, management is unwilling to pay out dividends if the earnings are not there, thus becoming an effective safeguard against managerial abuse of shareholder capital.

3. Predictable and dependable stream of income

"In this world nothing is certain but death and taxes." – Benjamin Franklin

If Benjamin Franklin had been alive to witness the development of the capital markets he might have included "dividends" in his famous quote. Over the last 80 years, reinvested dividends account for more than 35% of the total appreciation in stock prices (Source: Dow Jones). The safety and reliability of dividend payments for income-oriented investors also offers protection against inflation.

4. Both defensive and offensive

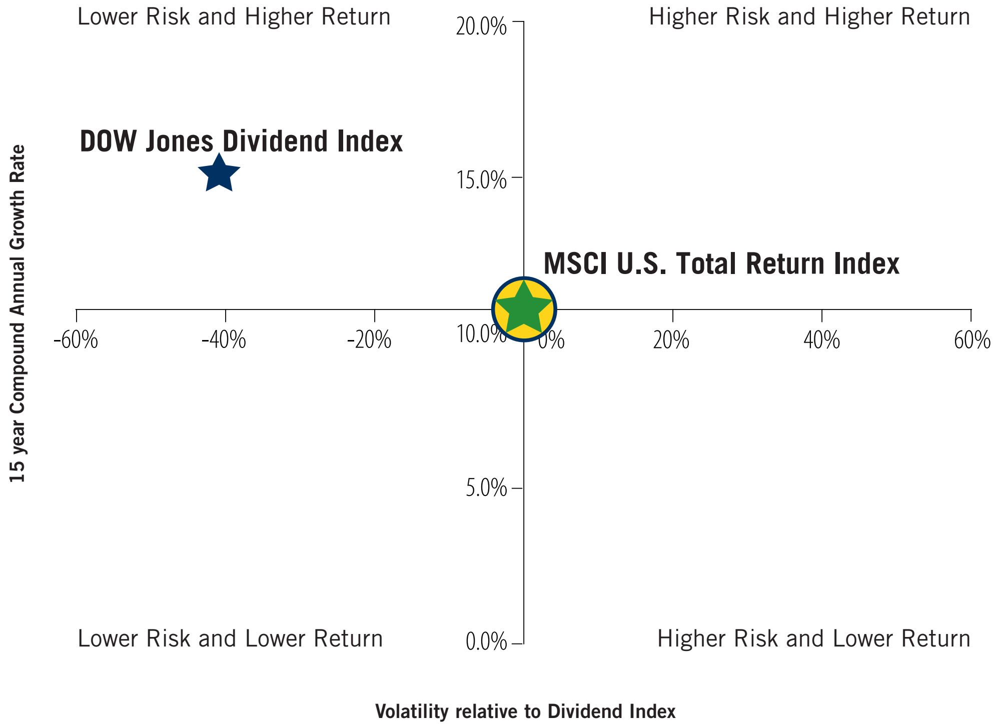
"Successful investing is anticipating the anticipations of others." – John Maynard Keynes

Realizing where investors' demand will emerge during market downturns becomes a critical point in the construction of a defensively positioned and well-diversified portfolio. Stocks that pay dividends provide a return regardless of stock market conditions and price fluctuations. This is one reason why investors have shown relatively stronger demand for dividend-paying stocks during market downturns. The strong balance sheet and high profitability of a dividend-paying company will act as a hedge through a period of market volatility.

A great example of this can be seen in the chart above. It illustrates that from March 2000 to March 2003, the Dow Jones U.S. Dividend Index outperformed during the longest downturn in global equity markets since The Great Depression. And from March 2003 to October 2006, the same index outperformed during the recovery.

5. Provides superior risk/return trade off

If you compare the Dow Jones Dividend Index to broad MSCI U.S. Total Return Index, you see that not only has the Dow Jones Dividend Index outperformed in returns over the last 15 years, it has done so with significantly less volatility (as shown in chart to right).



Source: Dow Jones March 1992 - September 2006

Case for going global now

1. Higher dividend yields

There is little doubt that dividends are a critical source of shareholder returns over the long term and international stocks can provide even greater opportunities for investors. The dividend yield for the Canadian and U.S. stock exchanges has averaged 1.5% to 2% over the last decade (Source: Dow Jones). This is much lower compared to consistently higher European stocks. In fact, the U.K. benchmark stock exchange (FTSE 100) has generally returned a dividend yield twice that of North American exchanges, and in the past three years, it has ranged between 3.5% to 4% (source: TD Economics).

Dividends may also be considered a critical source of equity returns. Over a 20-year period in Canada, the U.K. and the U.S., reinvested dividends accounted for two-thirds of the return on equities (source: TD Economics). Looking ahead, with a low inflation, low interest rate environment, dividend yields should continue to be a valuable source of investment income.

2. Greater investment opportunities

Canada represents just 3% of the global market, which means that far more investment opportunities lie in other parts of the world.

Today more than 47% of the world's investment opportunities, as measured by capitalization, are outside the U.S. (source: Morgan Stanley Capital International). Therefore, it makes sense to diversify and think globally.

If you focus your investment portfolio solely in Canada or the U.S., you could be missing many attractive opportunities.

Increased trade, the emergence of the Asia-Pacific markets, new markets in Eastern Europe and Latin America, a revitalized Japan, and the rejuvenation of Europe's industrialized economies have produced better balanced worldwide economic expansion, less reliance on the U.S. consumer, and sparked the growth of many foreign companies.

Today, several of the world's major industries – from consumer durables to diversified financials – are dominated by companies based outside North America.

- 9 of the 10 largest consumer durables companies
- 7 of the 10 largest insurance companies
- 6 of the 10 largest banking companies
- 6 of the 10 largest household and personal product companies
- 5 of the 10 largest diversified financial companies

Source: Forbes 2006

By investing solely in the Canadian or U.S. equity market, investors are excluding a major portion of the world's investment opportunities and, more important, some of the best companies in the world.

3. Enhance diversification

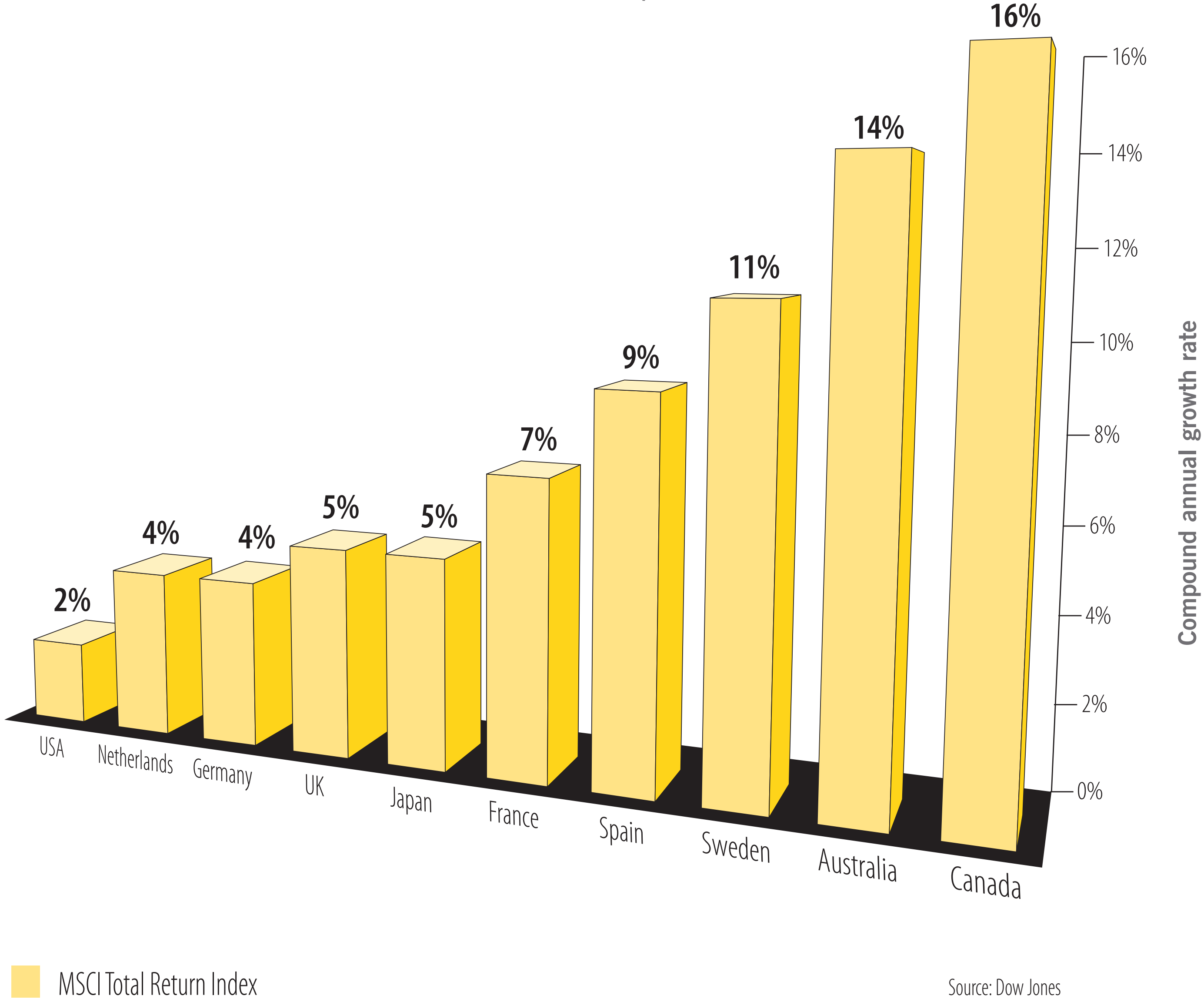
Adding foreign equity investments to your portfolio of Canadian equities gives you the opportunity not only to enhance your return but also reduce overall risk, the principal advantage of diversification.

Like economic cycles, foreign stock markets generally do not move in tandem with each other over the long term. While one or more foreign markets may, at any time, be heading in the same direction as Canada, longer-term correlations are low, thus providing some counterbalance to your portfolio.

4. Timing

While it is true that foreign markets have lagged a hot domestic economy, it is unlikely Canada can sustain this rate of overachievement for a prolonged period of time (see graph below). Foreign markets have outperformed Canada in the past, which would indicate that now is the time to invest globally before foreign returns revert to historical averages.

Can Canada possibly sustain this rate of overachievement?
MSCI Total Return Index
December 1998 to September 2006



Source: Dow Jones

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Advantages of dividends

There are a number of advantages to investing in dividend-paying equities:

Attractive returns:
Companies that pay dividends are generally viewed as being historically stable businesses that can afford to share profits with shareholders. When a company increases its dividend, it is typically well-received news because the firm is confident of its future growth.

Reduced volatility:
Stock prices of companies that distribute reasonable dividends may be less volatile than companies that don't pay dividends. The dividends paid, which is one part of total return, helps mitigate against the potential depreciation of a company's stock price, thereby reducing volatility.

Capital preservation:
Paid dividends are a tangible benefit. Therefore, paid dividends may lessen the economic impact of a drop in stock prices, or add to it if stock prices increase. Companies that pay dividends tend to be large capitalization companies in mature industries with stable earnings visibility.

Yield:
Dividends provide income. But they are only part of an investment's total return.

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