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Portfolio Strategy

INDUSTRY UPDATE

May 16, 2019

Introducing Canada's Undercover High Yield Market...

The S&P/TSX!

Our Conclusion

The continual decline in global interest rates has been a challenge for most yield-oriented investors. With a limited corporate bond market, no meaningful high-yield options, and few of the tax-driven alternatives that exist elsewhere in the world, Canadian investors seem to have nowhere to turn.

But there are solid opportunities for yield hiding in plain view. The S&P/TSX current yield is essentially in line with its long-term average, as are payout ratios, and it offers some of the highest historical relative yields when compared to fixed income alternatives.

Implications

Canadian equity returns have historically been highly dependent on dividends. In Canada, roughly one-third of total returns arise from the dividend yield. The comparable contribution in the U.S. is closer to 25% from dividends and 75% from price appreciation.

Five groups of stocks - Banks, Pipelines, Telecoms, Utilities and Real Estate - generate close to 60% of the dividends paid by the S&P/TSX, even though they only make up about 40% of the market capitalization. Furthermore, these companies have become an increased percentage of the index over time.

Even this says nothing of the substantial benefits that individual taxable investors get from dividend income, in comparison to that offered for interest income. In most provinces, interest income is taxed at one-third higher rates.

To be clear, owning equities carries higher risks than owning bonds. Bond coupons are binding commitments while dividends are paid at the discretion of an issuer's Board of Directors. Furthermore, equity prices are more volatile. However, with a substantially higher after-tax yield, and reasonable diversification across the S&P/TSX, investors who are income-oriented should consider Canada's "Undercover High Yield" market.

All figures in Canadian dollars, unless otherwise stated.

For required regulatory disclosures please refer to "Important Disclosures" beginning on page 8.

Dividends Are A Big Component Of Canadian Equity Returns

There is nothing quite like a dividend. Reported earnings, earnings growth and reported cash flow are great to have, but there is a higher degree of comfort when a shareholder receives cash from an investment. In Canada, dividends take on even more importance for an investor than they do in the U.S. – for two reasons.

"Lies, damned lies" and accounting standards

First, Canadian public companies report their financial statements based on International Financials Reporting standards (IFRS). While this approach has some advantages over rigid U.S. Generally Accepted Accounting Standards (GAAP), there does appear to be more "flexibility" in IFRS. The most recent example of this was with the adoption of IFRS 16, where we saw some companies disclose that their "free cash flow" changed as the result of an accounting standard change. This hardly inspires confidence in commonly reporting metrics, and reinforces the importance of dividends.

The second reason Canadian investors should care more about dividends than their U.S. counterparts is more tangible. Dividends make up a bigger proportion of the long-term returns from equity ownership. As we show in Exhibit 1, over the past 30 years (and over even shorter time frames) dividends have made up over one-third of Canadian equity returns – a meaningfully higher proportion than for U.S. equity returns.

Exhibit 1. Breakdown of Total Return CAGRs on the S&P 500 and the S&P/TSX Composite Over Time

	S&P 500 Total Return Breakdown			
CAGRs	Price Return	Dividend Return	Total Return	% DivRtn of Total
1 Yr	11.2%	2.2%	13.5%	16.7%
2 Yrs	11.2%	2.2%	13.4%	16.6%
5 Yrs	9.4%	2.3%	11.6%	19.6%
10 Yrs	12.9%	2.4%	15.3%	15.6%
20 Yrs	4.0%	2.0%	6.0%	33.3%
30 Yrs	7.7%	2.3%	10.0%	23.3%

	S&P/TSX Comp. Total Return Breakdown			
CAGRs	Price Return	Dividend Return	Total Return	% DivRtn of Total
1 Yr	6.2%	3.4%	9.6%	35.1%
2 Yrs	3.1%	3.2%	6.3%	50.2%
5 Yrs	2.5%	3.1%	5.6%	55.3%
10 Yrs	5.9%	3.1%	9.1%	34.7%
20 Yrs	4.4%	2.6%	7.0%	37.3%
30 Yrs	5.1%	2.7%	7.8%	34.5%

Source: Compustat and CIBC World Markets Inc.

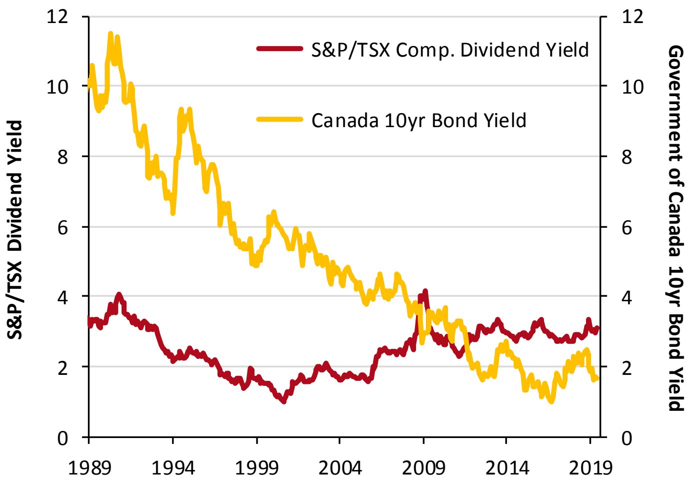
S&P/TSX Is Particularly Attractive Vis-à-vis Bonds

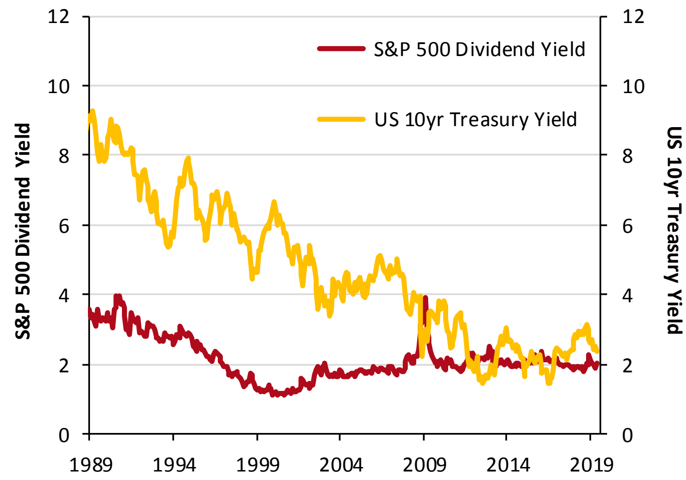
Over the past three decades, the S&P/TSX has had yields ranging from 1% to 4% - the upper bound coincided with equity corrections in the early 1990s and the Financial Crisis, while the lower bound coincided with the Tech bubble (Nortel). The current 3% yield is close to the last 30-year average.

Stocks continue to offer higher yields – particularly in Canada

Yields might be on "average" for the Canadian equity market but that is not the situation for bond yields. In Exhibit 2, we show both the yield on equities and the yields on 10-year relevant government bonds. In Canada, until the Financial Crisis, equities yielded less than bonds with the underlying logic that bond investors essentially had "capped" returns while equity investors participated in the growth of dividends over time. As such, bonds needed to yield more. With the Financial Crisis, sentiment changed such that investors developed much higher risk aversion, pushing up demand for government bonds (so lower bond yields), while investors demanded higher equity yields given lower confidence.

Exhibit 2. S&P/TSX and S&P 500 Index Dividend Yields Relative to Canada and U.S. 10yr Government Bond Yields





Source: Compustat, Bloomberg and CIBC World Markets Inc.

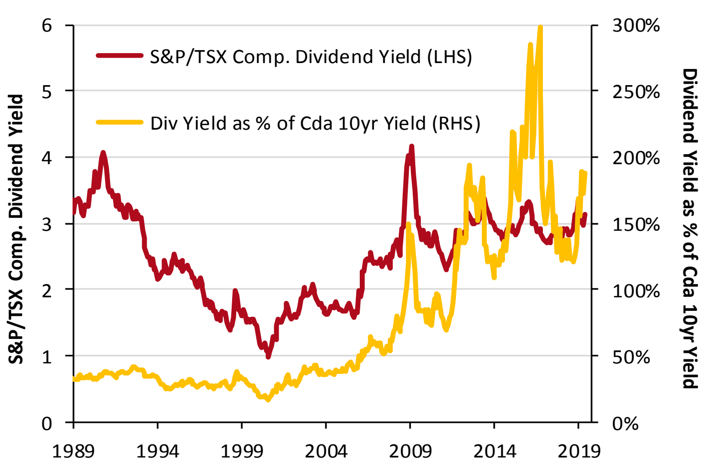
In the U.S., the situation is similar but not identical. Equity yield is not as low as in the Tech Bubble, but still low compared to its three decade average. On the interest rate side, the decline in 10-year rates has also been relatively continual – though we are at levels that exceed the troughs of 2012 and 2016.

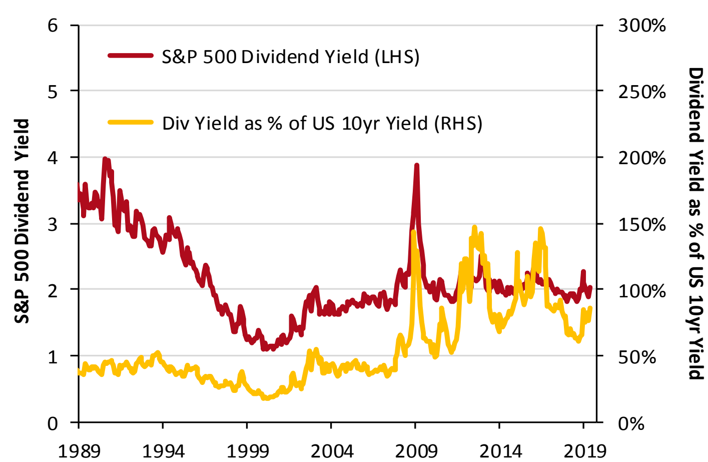
Relative yield = yield on equity / yield on bonds

Another way to consider the interaction of fixed income yield and equity yield is to calculate relative yields – the yield on equity indices relative to the yield on government 10-year bonds. Note the conclusions are relatively similar if we use other parts of the curve, but we believe longer-dated fixed income yields are more relevant for valuation metrics.

As we show in Exhibit 3, equities in Canada and the U.S. yielded less than 50% of fixed income yields for the 20 years until 2007 when bond yields plummeted. Since that period, equities have essentially offered comparable or better yields than fixed income. This situation is even more extreme in Canada, where equities now offer close to twice the yield on government bonds (given the flat shape of the curve, it won’t surprise anyone that there is equity yield premium across all durations in Canada) - relative yield of nearly 200%!

Exhibit 3. S&P/TSX and S&P 500 Index Dividend Yields as a % of Canada and U.S. 10yr Government Bond Yields





Source: Compustat, Bloomberg and CIBC World Markets Inc.

Premium Equity Yield Not Due To Higher Payout Ratios

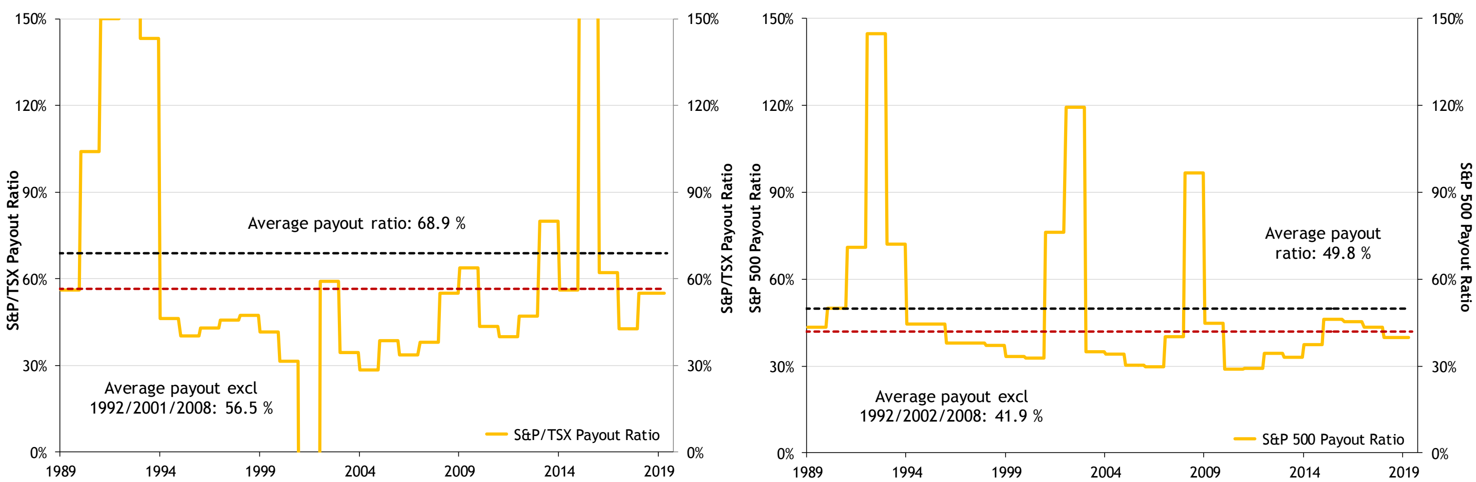
Dividend yield is a derivative of dividends paid, and price – two interconnected variables. Whereas price is driven by a number of factors (sentiment not the least of these factors), dividends are paid out of the cash flow and earnings companies generate. Too high a payout ratio and the dividend is vulnerable to management missteps or business cyclicality. The good news is that outside of a major economic slowdown, payout ratios look reasonable.

Payouts are volatile but look reasonable currently

To state the obvious, business profitability is subject to economic cycles. However, company Boards are very reluctant to cut dividends as long as they think earnings will recover in a reasonable period of time. As such, payout ratios can be quite volatile.

In Exhibit 4, we show payout ratios across for the S&P/TSX and the S&P500. Currently in Canada and the U.S., payout ratios are slightly below their long-term averages. We also show the "average" payout ratio excluding the periodic spikes and troughs than one would expect from the business cycles – essentially removing data points from early 90s, the Tech Bubble and the Financial Crisis. Not surprisingly, this "average" is lower and is probably a better benchmark to evaluate sustainability given the benign economic conditions. Even against this more conservative average, payouts look reasonable.

Exhibit 4. S&P/TSX & S&P 500 Payout Ratios



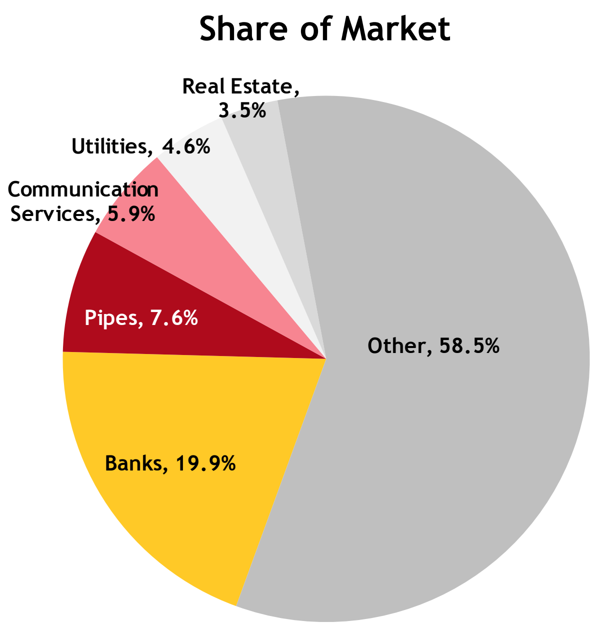
Source: Compustat, CapIQ and CIBC World Markets Inc.

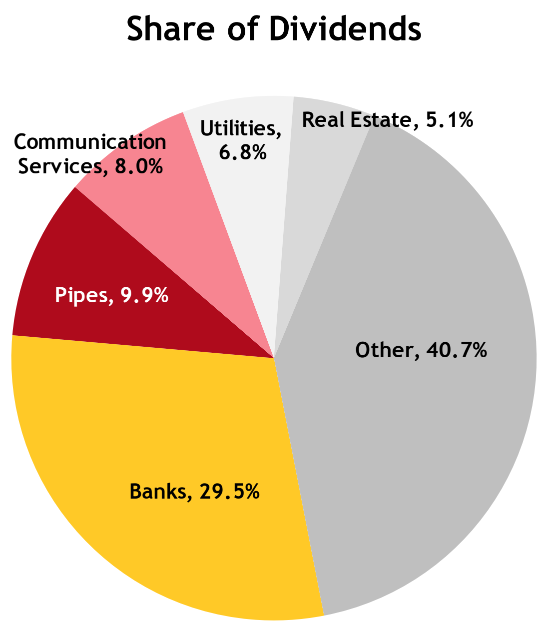
Canadian payout ratios (using earnings) have on average been higher than in the U.S. largely as a result of the higher exposure to Resource stocks – Materials and Energy. In these sectors, high capital expenditures and depreciation create a meaningful gap between earnings and cash flow.

The S&P/TSX is "yielding" to yield stocks

So if payouts are below average, how can yield on the S&P/TSX be above average? The answer is multifaceted but the main reason is composition of the index. The major dividend paying sectors are Banks, Pipelines, Telecoms, Utilities and Real Estate. In fact, as we show in Exhibit 5, these five groups pay close to 60% of the dividends within the S&P/TSX, but represent just above 40% of the market capitalization.

Exhibit 5. Five Groups of Stocks (41.5% of the Cap) are the Dominant Dividend Payers (59.3% of Total Dividends)

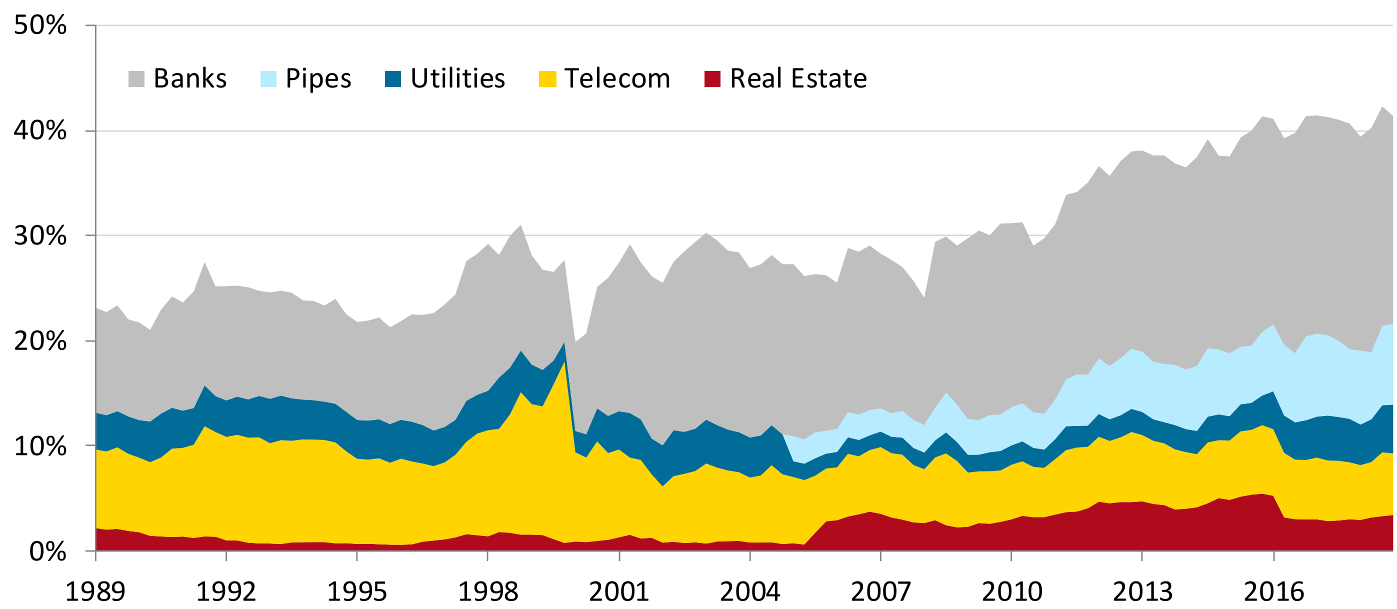




Note: For the purposes of simplicity, we have used Communications Services, which is 95% Telecoms.
Source: Compustat, CapIQ and CIBC World Markets Inc.

It is the growth in these sectors that has caused overall S&P/TSX yields to be high even though payouts remain in line with long-term averages. As we show in Exhibit 6, Banks and Pipelines are bigger proportions of the equity market than they have ever been. Real Estate and Utilities are also very meaningful but now off their previous peaks. In the case of Telecom, its market capitalization in the pre-2001 period was “exacerbated” by the ownership of Nortel by Bell so the spike in 2000 is probably less relevant.

Exhibit 6. Float Capitalization of Yield Sectors Relative to the S&P/TSX



Source: Compustat, CapIQ and CIBC World Markets Inc.
Note: Pipelines were included in Utilities until shown separately in the chart.

Canadian Taxation Argues Further In Favor Of Dividends

Investors often focus on “headline” yield rather than “after-tax” yield. This may make sense for pension plan managers but for most other investors, this is too simplistic an approach. In Canada, this is particularly true given the differential tax treatment for different forms of “yield”. As we show in Exhibit 7, the tax rate differential on interest (considered Income by Revenue Canada) for high income residents is extreme – 1300-1600 bp higher than for dividends.

Tax rates on interest is one third higher than on dividends

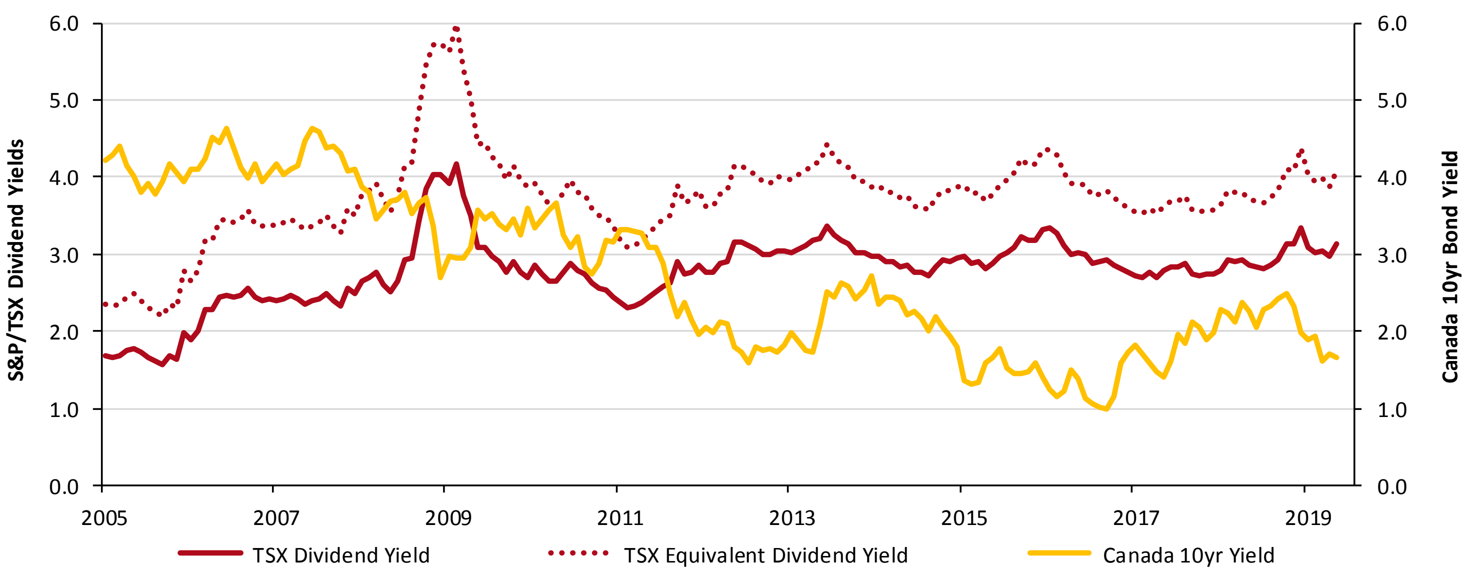
Exhibit 7. Tax Rates For High Income Canadians By Province

	Tax Rates for High Income Canadians			Tax on Income
Province	Income	Capital Gains	Dividends	vs Dividends
Ontario	53.5%	26.8%	39.3%	14.2%
Quebec	53.3%	26.7%	39.8%	13.5%
Alberta	48.0%	24.0%	31.7%	16.3%
BC	49.8%	24.9%	34.2%	15.6%

Source: PwC and CIBC World Markets Inc.

Another way to highlight the importance of including taxation is to compare yield on equities versus fixed income, on a “tax-equivalent basis”. As we show in Exhibit 8, the taxable equivalent yield on Canadian equities is over twice that of on Government bonds. Note, our tax data only goes back to 2005.

Exhibit 8. S&P/TSX Composite Dividend Yield on a Tax-Equivalent Basis Relative to the Canada 10yr Bond Yield



Note: Exhibit assumes investor is a taxable high-income resident of Ontario.
Source: Compustat, Bloomberg, TaxTips and CIBC World Markets Inc.

The point of this analysis is as follows. Yes, most equity investments look cheap relative to bonds, given the very low bond yields. However, in Canada this situation is extreme. A diversified group of Canadian equity investments (also known as the entire S&P/TSX) would provide twice the “after-tax yields” offered by 10-year Canada bonds. So much for Canadian investors saying there aren't good options for attractive yield with manageable risk!

For Equity Cynics In The Audience…

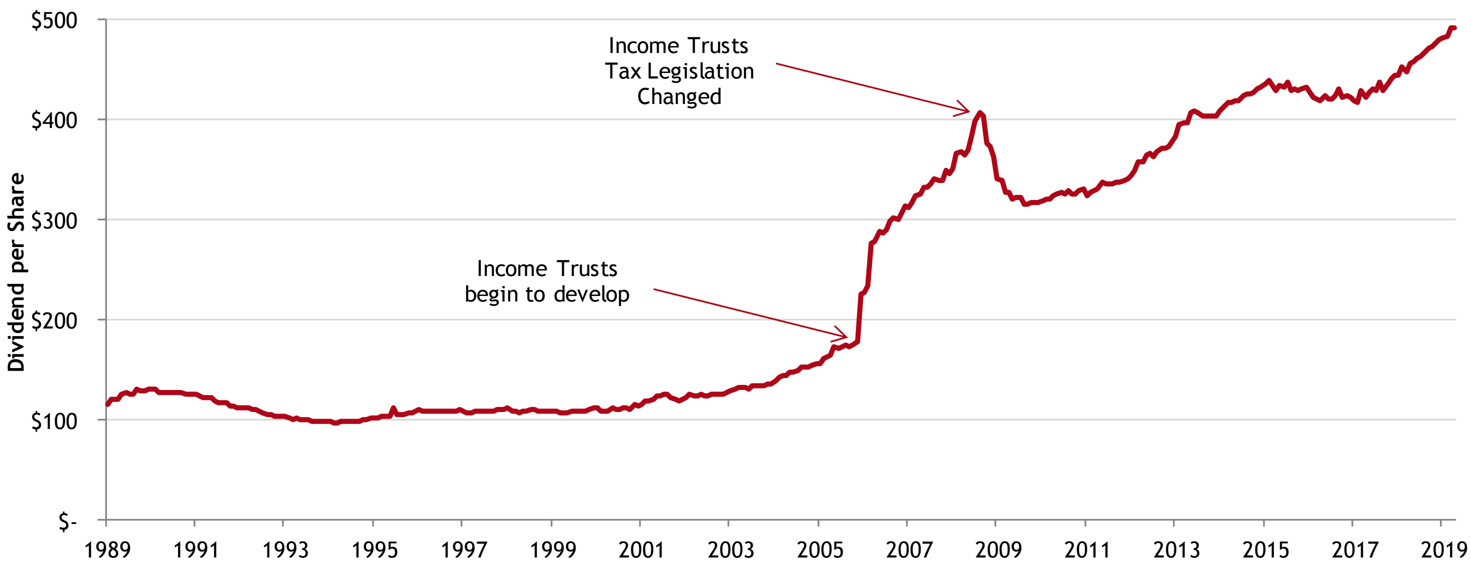
Yes, equities are riskier than bonds

To be clear, we are not saying that risks associated with bond ownership and equity ownership are identical – they aren't. The coupon on a bond has far more precedence than the dividend paid to an equity holder. A bond holder effectively has a legal "commitment" from the issuer to pay a certain amount, on a periodic basis, until maturity. To abrogate the commitment, the issuer likely needs to file for bankruptcy!

A dividend paid by an issuer is completely at the discretion of the issuer's Board of Directors, and can be reduced without legal recourse. Of course, there would be ramifications if a dividend was cut – likely the stock price would decline but that is not akin to breaching a legal commitment, or to bankruptcy, which would proceed a missed coupon payment. We would also note higher price volatility associated with equity investing.

However, when talking about a diversified index such as the S&P/TSX, actual dividend cuts in aggregate are very infrequent, and are almost always associated with major recessions. Exhibit 9 tracks the history of dividend per share payments by the S&P/TSX since 1989. Outside of the income trust debacle, which temporarily inflated dividend per share, the S&P/TSX has only had two declines in the past 30 years. The most recent was a 4% decline in dividends when oil prices collapsed in 2016, as high-payout energy companies were finally forced to cut their distributions.

Exhibit 9. S&P/TSX Index Trailing 12 Months Dividend Per Share, 1989-2019



Source: Bloomberg, Compustat and CIBC World Markets Inc.

The decline in the early 1990s was more extreme (about 20% after normalizing for some one-time dividends paid in the late 1980s) and reflected the Commercial Real Estate collapse in North America – remember the Reichmanns and their control of O&Y and GW Utilities?

Twice the yield is compensation for periodic risk

So to repeat, equity yield is riskier than bond yield, but how much more risky? For purposes of comparison, we could conservatively assume S&P/TSX experiences an overall 10% dividend cut every 10 years. Given the huge after-tax yield gap versus bonds, even such a draconian scenario would still argue for equities. Furthermore, dividend cuts are invariably made up as other sectors grow their dividends. Over the period considered, dividend per share for the S&P/TSX was consistently higher over any five-year period.

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Restricted	9	2.7%	Restricted	9	100.0%

Ratings Distribution: Portfolio Strategy Coverage Universe

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Underperformer (Sell)	0	0.0%	Underperformer (Sell)	0	0.0%
Restricted	0	0.0%	Restricted	0	0.0%

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