DSR PREMIUM NEWSLETTER

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MAY 26TH, 2023

Dear DSR member,

It is with great pleasure that we present our weekly premium newsletter which is an important component of your subscription to Dividend Stocks Rock.

You may benefit from viewing our video explaining the differences between the Buy List, our ratings, and our portfolio models. You can retrieve this information in the Videos section of the website.

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LOW YIELD, HIGH GROWTH STOCKS AT RETIREMENT

I've discussed the importance of having low yield, high growth stocks in one's portfolio many times. Most of you have accepted that this type of stock usually generates the strongest returns. However, many of you think this strategy is better for younger investors in their accumulation phase.

At 60, I'll generate a 5% yield from my portfolio. That's a common belief that a 5% yield portfolio is a safe way to retire. I'm sorry, but I beg to differ.

I want to thank Greg, a DSR PRO member since 2020, who asked me for more detail on the comparison between low yield and high yield stocks at retirement. I had an interesting email discussion with him, and I wanted to expand the topic to a complete newsletter.

Warning: you may not like what you will read today. But I'm not here to be your friend. I'm here to be your hiking buddy and tell you there might be a bear on your investment path.

But instead of saying "believe me, I've seen the bear", I invite you to follow me on the trail to see it with your own eyes. But first, let's go back to explain why a company pays a low yield or a high yield.

WHAT MAKES A COMPANY PAY A LOW YIELD OR A HIGH YIELD?

Today, it takes 5.5 years for Alimentation Couche-Tard to pay 1 year of a Canadian Utilities' Dividends.

It also takes 122 years of a Canadian Utilities' dividends to equate to 10 years of ATD's total returns.

You probably have heard me say that in a podcast or in a recent webinar. That's my new favorite line to illustrate that once an investor focuses on one metric or factor, he/she may become blinded.

Again, one will argue Alimentation Couche-Tard's total return is not guaranteed for the next 10 years. I would argue that Canadian Utilities' dividends are not guaranteed either.

Just imagine if I had picked Visa (V) vs AT&T (T). That would have been a total disaster for AT&T's shareholders.

Just for fun, I ran the DSR stock screener searching for a list of stocks paying a yield under 2% but showing a 10%+ dividend growth rate over the past 5 years. Then, I looked at their total return (stock appreciation + dividend) graph for the past 10 years. I did that for 12 US stocks and 12 Canadian stocks. The results on the next page will show a range of growth from 203% to 1,300% for US stocks and from 210% to 782% on the Canadian market.

Long story short: those 24 low yield, high growth stocks killed it. For the record, an ETF tracking the S&P 500 (SPY) reported 201.6% in total return while the iShares TSX 60 (XIU.TO) was up 125.4%.

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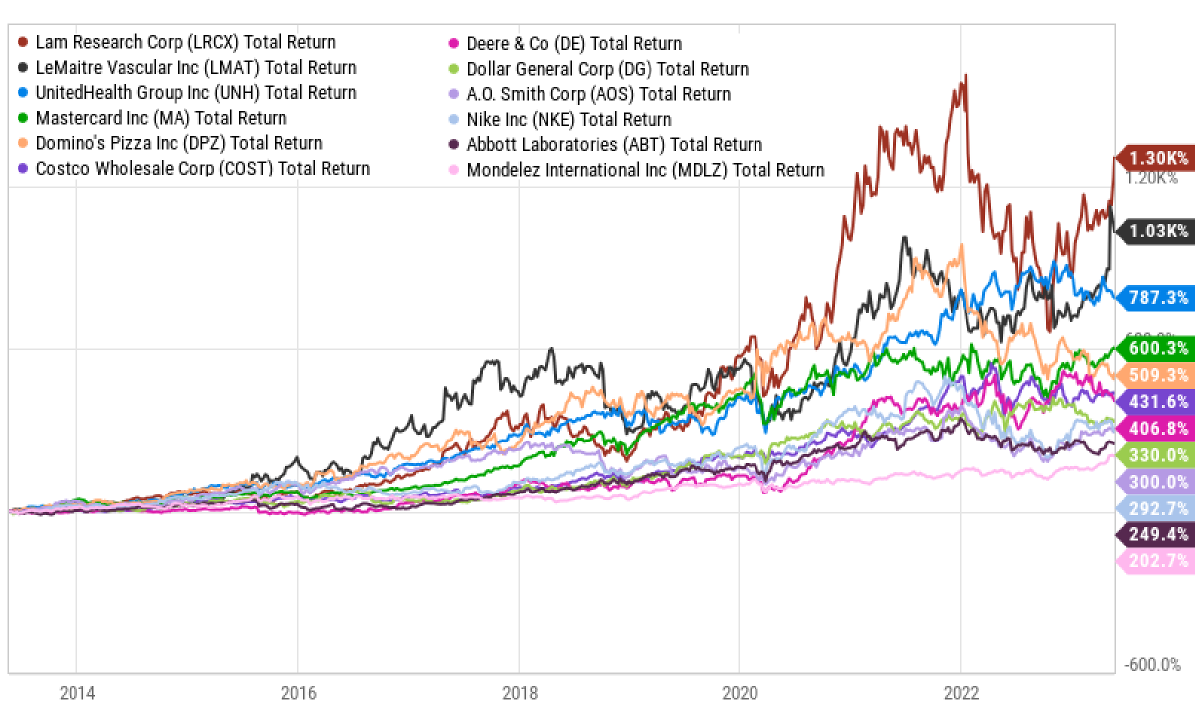

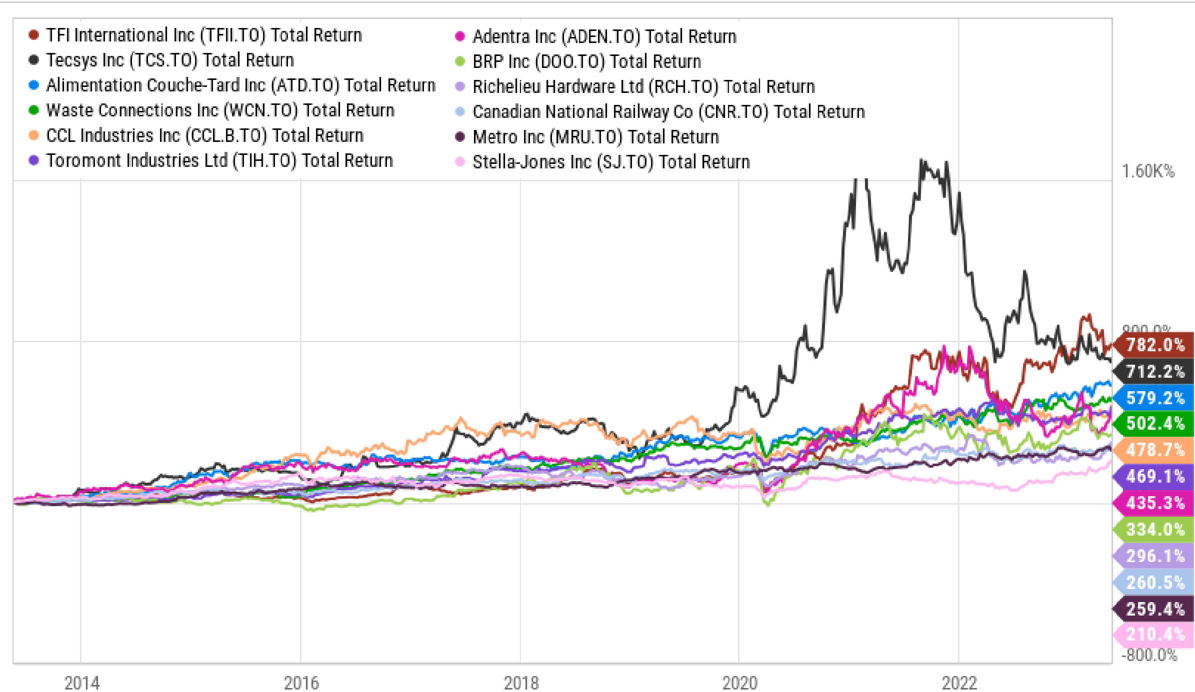

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As I mentioned at the beginning of this newsletter, most members would agree with me at this point. Many low yielding stocks come with a robust dividend growth policy (read high-single digit and often double-digit dividend growth rate).

Therefore, if you focus on total return, you want low-yield, high-growth stocks.

But the argument about building a high yield portfolio is still valid at this point. I get it as at one point in your life you may be more interested in getting paid in predictable increments than trying to figure out when is the right time to sell shares at their peak value.

You are probably concerned about selling shares period as you may be thinking you may hurt your portfolio. I'll address both concerns later in this newsletter. But I wanted to see how high-yield stocks (over 4-5%) did during the past 10 years. Remember, between 2013 and 2023, we had low interest rates, strong consumer confidence and a growing economy for the most part. In other words, it was the perfect timing to run a business.

I did the same type of research, but I made sure those companies were paying a high yield 10 years ago. Therefore, a company like Enbridge couldn't qualify as the yield in 2013 was around 3% (see how things change quickly in this world?). I've picked 12 US and 12 Canadian stocks (featured on page 5 and 6 of this newsletter).

First conclusion: high-yield stocks' performance is terrible compared to low-yield, high-growth companies.

Only two out of 12 US stocks could have made the first graph for performance (e.g., 200% total return) and none of the Canadian securities reached 200% total return. Even worse, 6 out of 24 (25%) reported a negative total return. In other words, you had a 25% chance of losing money (even after receiving the dividends) and only 16% (4 on 24) chances to match / beat the market.

Second conclusion: retiring on those dividend payments would have been deadly for your portfolio.

From that list, we find 8 dividend cutters (33%!) and 8 more that didn't increase their dividend enough to match inflation (dividend increase under 30% over 10 years). In other words, that's a 66.66% chance of investing in a company that doesn't protect your buying power at retirement.

That's also 66.66% of stocks that would greatly hurt your retirement plan.

Picking 48 stocks and pulling out a few graphs won't allow me to enter Harvard for my thesis. This is not an academic study, but it's enough to have a strong feeling that something is off when a company pays a yield above 5%.

There are also expectations both ways (bad low-yield stocks and great high-yield stocks). I'll let you digest the two pages of graphs and I'll get to the explanation behind the reasons why a company pays a low yield and grows its dividend generously.

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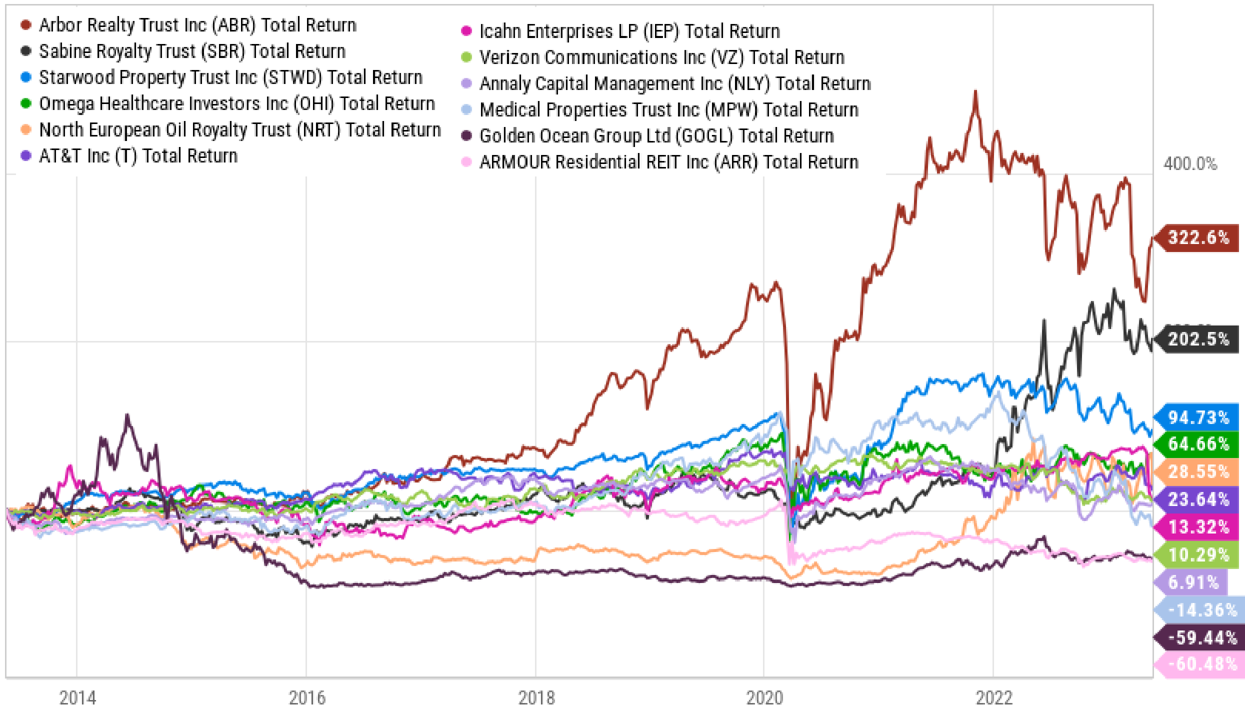

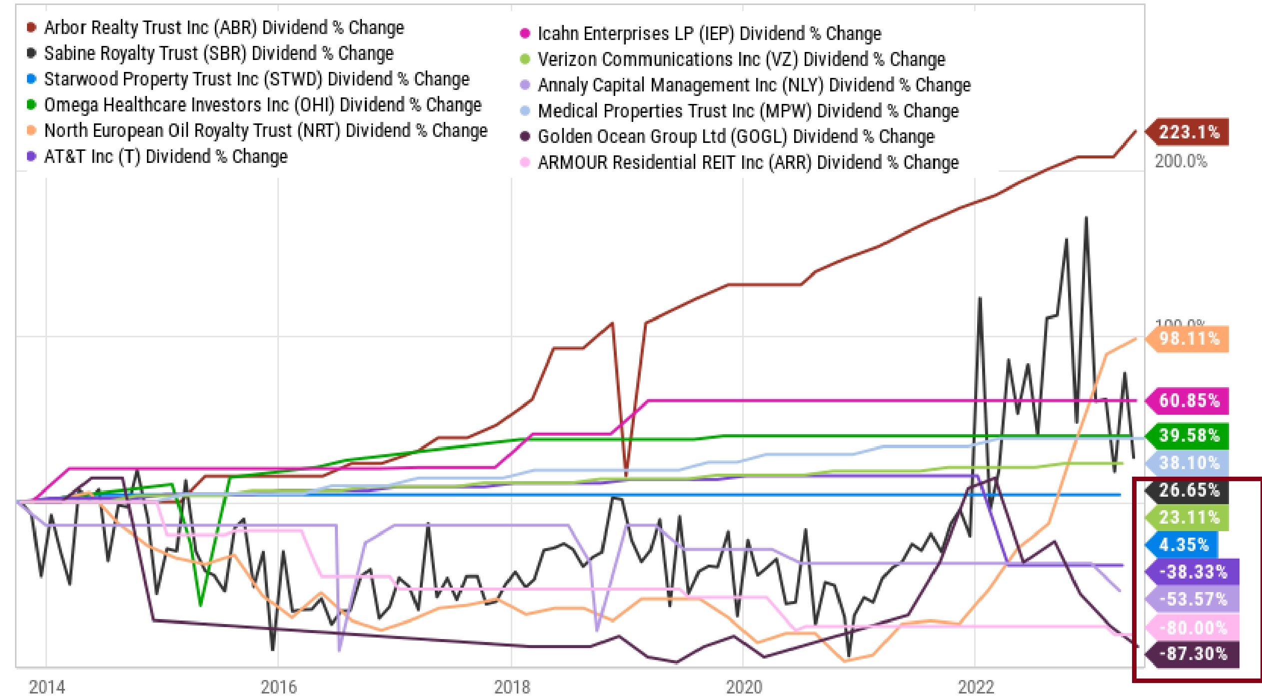

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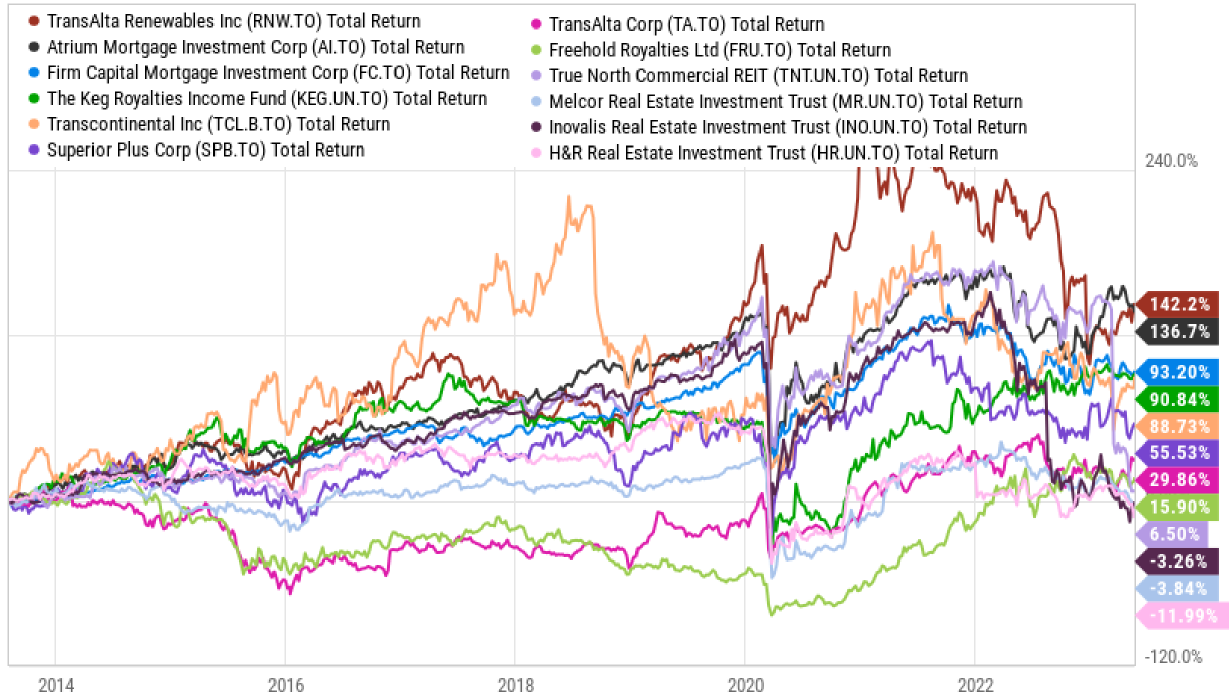

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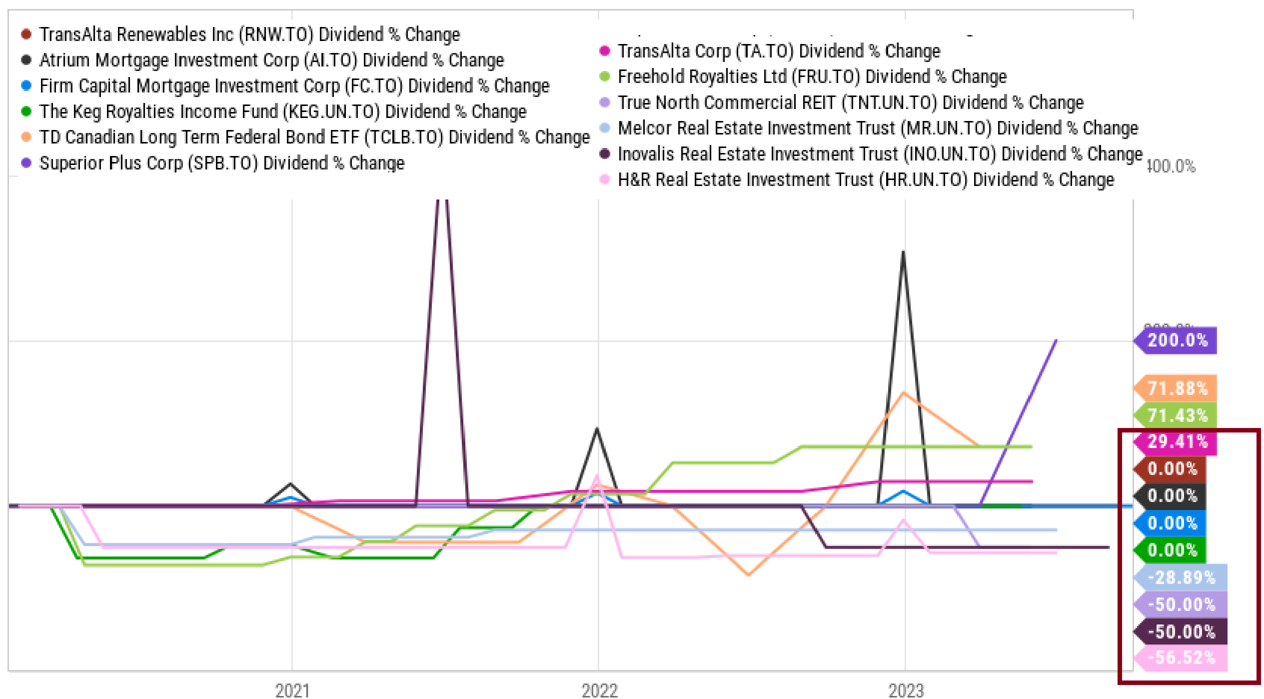

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There is a rational explanation

What is the difference between Visa and AT&T? Why Visa pays a yield under 1% while AT&T offers nearly a 7% yield? The explanation is found within the dividend triangle. Ignore the dividend payment for a second and concentrate on the business' health.

What makes our businesses great? Growth.

At DSR, I like to look at revenue growth (ability to generate more sales) and EPS growth (ability to generate more profit). It's a bit simplistic, but businesses growing their sales and profits consistently tend to be good investments.

Visa Inc Revenue (TTM) % Change
Alimentation Couche-Tard Inc Revenue (TTM) % Change
Canadian Utilities Ltd Revenue (TTM) % Change
AT&T Inc Revenue (TTM) % Change
168.6%
143.7%
80.00%
24.66%
-4.94%
-80.00%
Visa Inc Normalized Diluted EPS (TTM) % Change
Alimentation Couche-Tard Inc Normalized Diluted EPS (TTM) % Change
Canadian Utilities Ltd Normalized Diluted EPS (TTM) % Change
AT&T Inc Normalized Diluted EPS (TTM) % Change
480.4%
400.0%
326.7%
200.0%
77.86%
4.09%
-200.0%
2014
2016
2018
2020
2022
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What you see on this graph is two low-yield, high growth stocks (Visa & Alimentation Couche-Tard) vs. two high yield, low growth stocks (AT&T and Canadian Utilities). We can draw two conclusions from this graph:

Conclusion #1 low-yield, high-growth stocks show a strong ability to grow their sales.

Conclusion #2 low-yield, high-growth stocks are even better at growing their profits.

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We can deduct that both companies benefit from strong growth vectors and are also able to expand their margins along the way. In other words, they are growth stocks that happen to pay a dividend. The dividend is small because the companies are growing very fast, and often at double-digit growth rates.

On the other hand, high-yield, low-growth stocks are mature businesses with limited growth potential. They are trying to make moves to generate growth, but it doesn't always work. AT&T completely failed in its attempt to participate in the media & entertainment industry and ended up cutting its dividend and spinning-off its media segment.

Conclusion #3: Higher-yielding stocks show mature businesses with less growth potential.

Unfortunately, the line is often thin between being mature and generating growing cash flow (enabling a minimum of dividend increases) and struggling slowly, but surely (and eventually cutting its dividend). Here are two examples of high yielders that are coming to that crossroad (IBM and Transcontinental TCL.B.TO).

In both cases, the inability to find growth has already weighed in on their ability to generate more profit and starts to weigh on their ability to grow their dividend. The problem with higher yielding stocks is that we will often end-up with this conclusion: they once were great companies, now they may be marginal companies.

Their weak fundamentals may put your retirement at risk.

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The dividend mechanic vs. the dividend magic

Dividends aren't magic money deposited into your account.

The other aspect to consider is why a company is paying you a dividend in the first place?

When we receive money, we don't always want to know where it's coming from, and we would rather focus on what we will do with it. But we should dig further.

By definition, a company pays a dividend when it is unable to create value for shareholders. In other words, a company would rather pay you $1 in dividend if it cannot find a good project to invest in with that same dollar. Management has investigated marketing spending, research & development, acquisitions, hiring talent and more. They couldn't find anything that was worth the investment. Therefore, they transfer that responsibility into your hands and call that a "dividend". You, as a shareholder, now have the responsibility to allocate that dollar and find a better investment.

Therefore, a company paying a lower yield will likely show a lower payout ratio since the business is growing so quickly. This also means that management is able to find plenty of projects to generate value (e.g. stock price increase) for shareholders. The dividend mechanic is a simple money transfer from one bank account to another.

It doesn't mean there is no magic.

The magic happens when you find DIVIDEND GROWERS. Dividend growers are companies that can increase their dividend every year. This means they must be able to grow their sales and profit accordingly to maintain their dividend growth policy.

Again, who doesn't want to invest in a company growing their sales and profit? Dividend growth is the result coming from a great company with a great business model and a robust balance sheet.

Unfortunately, we find fewer of those amazing companies amongst high yielders. Low-yield, high-growth stocks don't have the monopoly on being great companies, but there are many more great companies amongst the low yield, high growth stocks.

So why in the world would retirees tend to ignore them? Because they don't pay the bills and are seen as potentially risky.

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WHY LOW YIELD STOCKS ARE IGNORED?

If I had to answer this question in one sentence, I'd say because they make retirement planning complicated. Nobody wants to figure out how many shares they must sell each year on top of getting their dividends, their pension income and more. In other words, "low yield stocks don't pay the bills", or do they?

They don't pay the bills.

Let's take the example of ATD.TO and V and imagine you invested $10,000 in each of them in 2013. In late May of 2013, you could buy 1,031 shares of ATD.TO at ~9.70/share and 222 shares of V at ~$45.05. 10 years later, those shares are trading at $66.01 and 231.30, respectively. Imagine you did the same with T and CU.TO and you reinvested those dividends and bought more shares. Today, you have a portfolio that is worth almost $150K… with 123K invested in the low-yield stocks!

Alimentation Couche-Tard Inc (ATD.TO) Total Return Growth
Visa Inc (V) Total Return Growth
AT&T Inc (T) Total Return Growth
Canadian Utilities Ltd (CU.TO) Total Return Growth

$80.00K $72.00K $64.00K $56.00K $48.00K $40.00K $32.00K $24.00K $16.00K $8.00K $0.00
$66.00K $60.00K $48.00K $42.00K $36.00K $30.00K $24.00K $18.00K $6.00K
$67.92K $55.11K $14.45K $12.36K
2014 2016 2018 2020 2022

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I don't want to sell my shares to generate income.

The more you sell shares, the less you must generate income.

Let's look at this example at retirement and imagine that you retire today with no more dividend reinvestment, and you just want to live off your dividends. Let's look at what the dividend brings:

ATD.TO: 0.85% * $67,920 = $577.32

V: 0.77% * $55,110 = $424.35

CU.TO: 4.72% * $14,450 = $682.04

T: 6.81% * $12,360 = $841.72

Interestingly, your low-yielding stocks generate $1001.67 and your high yield stocks generates $1,523.76.

You see, Mike, high yield generates more income!

I agree, in fact, it's a little more than 50% more! However, I have $123K invested in the first two stocks and $27K in the high yielders.

If I sell for $523 of ATD.TO to compensate, the following year, my shares will generate 0.85% * 67,397 = $572.87 or ~$5 less than last year. That is, without considering any capital gain or dividend increases.

I could probably do this operation for another 100 years and I will still have money invested in both ATD and V.

Conclusion: selling shares of low-yield, high-growth stocks have a small impact on the ability to generate the basic dividend.

One could argue I could sell my ATD.TO and V shares and buy more of CU.TO and T to generate a higher income. From the chart I've pulled at the beginning of this webinar I wouldn't feel confident with 66% of chances to see my retirement income depleting once we factor inflation. This seems like the perfect path to eat a lot of peanut butter and jelly toasts and Kraft Dinners.

Retiring on low yielders is dangerous

I needed to address this point loud and clear as some investors think low yielders are dangerous as their performance is solely coming from stock price appreciation. I think I made it clear over the past 10 pages of this newsletter how **low-yield, high-growth stocks offer protection rather than a risk.** Companies that are growing their revenue and earnings by high-single to double-digits will attract investors. If they attract investors, the stock price trends will remain solid. The 24 low-yield stocks I've picked at the beginning of this newsletter show you convincing results. But on top of strong performance, there are more advantages of investing in them.

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MAIN ADVANTAGES

I'm a big believer in understanding why you hold shares of specific companies and understanding how these companies will contribute to your retirement plan. Now that we have discussed the outperformance of low-yield, high-growth stocks, let's see why they perform that well.

Exposure to the 5 factors

If you have done any research about market performance, you rapidly fell on academic papers discussing the 5 factors explaining most of the stock market return. Interestingly, many financial advisors or dividend adverse investors will pull out those studies to tell you dividends are irrelevant. According to them, dividend growth is a symptom of a strong exposure to the 5 factors:

1. **Market beta** (Invest in stocks that collectively have lower volatility than the broad market)
2. **Size** (Invest in smaller, and more nimble companies)
3. **Value** (Invests in stocks that are lower cost relative to their peers)
4. **Momentum** (Invests in stocks that are outperforming and reduce exposure to stocks that are underperforming)
5. **Quality** (Invests in companies with strong financials relative to similar cost peers)

Source: BlackRock

I would rather say that dividend growth is a result of thriving companies that are exposed to those factors. We have determined that the chances of picking a high yielder that is also a thriving company are slim. However, if you look at low-yield, high-growth companies, they are usually checking many of those boxes.

Long-term wealth preservation

Based on the graph provided in this newsletter, I'd say it's safe to conclude that thriving companies offer great protection for your portfolio. As those companies grow, their share prices increase. That's just pure logic. Therefore, selecting high-quality companies with a generous dividend growth policy is a better strategy than selecting companies based purely on yield.

Sustainable income growth

I'm not going to tell you that you should aim to build a portfolio with a yield under 2% after reading this newsletter. However, by adding a few of those low-yield stocks, you increase your chances that your portfolio income grows and beats inflation. If you retire at 60 and need $50K income from your portfolio, this means you will need $68K from the same portfolio at 75 and $84K at 85 (assuming inflation at 2.10%). Now, imagine your portfolio's dividends aren't growing at this pace. Even a 2% inflation rate could derail your retirement plan.

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LOW YIELD OR HIGH YIELD? THE SOLUTION

I understand that you will not sell all your stocks paying a 3%+ yield this weekend. You don't have to. I think you can create a good balance between a few high yield (5%+), some moderate yield (between 2% and 5%) and some low yield (under 2%) stocks. This could be a great way to build a solid portfolio.

Diversification is everything

If there is one thing I have learned from my 10 years in the industry as a financial planner it is that diversification is everything. Make sure you have exposure to various assets, markets, sectors and industries and you will be covered. By increasing your level of diversification through the diversification of your dividend income sources and yields, you increase the sustainability of your retirement income.

Instead of focusing on yield, why don't you focus on high quality stocks, no matter what the yield is?

Homemade dividend

What if I need more income than my portfolio yields?

That is a question many retirees will ask. If you invest $1,000,000 with an average yield of 3.5% but you need $50,000 to retire, you see a $15,000 shortfall. How can you solve this problem? Possibly by creating your own dividend.

We have demonstrated how you can sell shares of your thriving companies without hurting your portfolio. To make sure you don't have to sell during a bad year, you can create a cash reserve through a 3 years GIC/bond ladder.

Imagine you need $50K from your portfolio, but you only generate $35K/year. You can then take $60K in a 3 years GIC/bond ladder. Here's what I got from RBC rates without looking anywhere else:

- $20,000 for 1 year at 3%
- $20,000 for 2 years at 3.25%
- $20,000 for 3 years at 3.30%

Then, you have the remaining invested in your portfolio (940K) at 3.5%.

That generates $32,900 per year and your GIC at the end of the first year will be $20,000 + $600 (1yr interest). That makes a total income of $ $53,500. You then have $3,500 extra that you can reinvest for another 3 years to keep the ladder going.

If it's a good year (e.g., your portfolio is up), you sell enough money to "refill" your bond ladder with another $16,500 to make it $20K (3.5K + 16.5K) to complete the bond ladder. Keep in mind that $16.5K on $940K is the equivalent of a 1.76% capital gain. Chances are, you'll be able to do that most years.

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Then, when you hit a bad year like 2022, you simply take the expired GIC and wait for the next year. With this system, you can wait 3 full years without selling a single share. Most bear markets take 18 to 24 months to fully recover. Therefore, you should be covered for most of the time.

Creating your homemade dividend coming from a robust portfolio will make retirement as stress-free as possible.

CONCLUSION

I hope I have shed some light in this newsletter on the rationale of adding some low-yield, high-growth stocks to your portfolio. The point is not to transform your entire portfolio and sell everything that is over 5% yield. In fact, you can find quality companies offering high yields as well.

The point is to ensure that all companies in your portfolio show strong fundamentals so they can continue to pay their distributions and increasing that payout to at least beat inflation.

If there are any points I didn't touch in this newsletter, please let me know and I'll address them in our next webinar in June.

Cheers,

Mike.

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