DSR PREMIUM NEWSLETTER

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This is your site and your exclusive newsletter. Please, feel free to share any ideas, opinions, comments, or suggestions with us via email at dividendustries@gmail.com.

AUGUST 16TH, 2024

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.

Referral

Feel free to share our ideas with your friends or associates who may benefit from this information. **We would personally consider any referrals you make on our behalf to be the ultimate compliment for our efforts.**

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TECHNIQUES TO AVOID DIVIDEND CUTS

After a bad year for the markets in 2022, we entered 2023 thinking the worst was yet to come. Then, there was a boost of confidence from the market driven by another "hype story": the rise of artificial intelligence (A.I.). While the S&P 500 is up double-digits, most of the return was driven by technology stocks (such as Meta, Alphabet, Apple, Microsoft, etc.). The Canadian market followed distantly (positive since 2023, but not as good as the U.S. market), but many of its dividend darlings (telcos, utilities, REITs, pipelines, and even banks!) made more than one investor curse over the past two years. While the money is made on tech stocks, classic blue chips have been left aside.

Then, we had a glimpse of hope as the Bank of Canada cut the interest rates twice and the FED seriously started thinking about doing the same. However, high interest rates and inflation continue to apply pressure on companies' margins and the next quarterly earnings won't be pretty for many.

As you can see, there seems to always be something lurking in the dark that could jump on your dear holdings and force the weakest link to break. If the recession happens as I expect it will, we'll see another round of *cost optimization for more financial flexibility and value creation for shareholders*. Well, this is how CEO's will present it anyway. Here's a good example from the Intel (INTC) Q2 earnings call transcript about their dividend:

*"We are taking the added step of **suspending the dividend at the beginning of the fourth quarter**, recognizing the importance of prioritizing liquidity to support the investments needed to execute our strategy. We reiterate our long-term commitment to a competitive dividend as cash flows improve to sustainably higher levels."*

Over the past two years, we have seen layoffs, budget cuts and, for the weakest companies, the inevitable dividend cuts.

I have a strong feeling that many investors have become quite complacent with their holdings (I hope it's not the case with you). After all, we haven't suffered too much since 2009. That's 15 years where we didn't have to wait more than 2 years to fully recover from a bear market. We have experienced bad markets during that period, but they were quickly erased from our memory as those markets bounced back quickly each time.

- ✓ 2018 20% drop: recovered during 2019.
- ✓ 2020 pandemic crash: recovered in 2021.
- ✓ 2022 interest rate market drop: once again, it quickly became ancient history.

Life isn't always going to be that easy – we may face a tough market going forward.

Companies feel pressure from the rising cost of materials, higher wages, and higher debt costs. This situation will not stop magically. While inflation is gradually slowing down, this only means that costs will not continue to rise as fast as before. **But we now must deal with higher prices on everything now.** Similar to your salary that won't go back to the 2019 level, companies must operate with higher costs everywhere.

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What about debt? That will last for a while too. As companies renew their debt, they will face higher costs. The same dynamic affects consumers who won't be able to avoid higher interest rates forever. Sooner or later, they will need to renew their mortgage or buy a new car. The higher interest rates will squeeze their budget and put additional pressure on the economy. This means companies will not only deal with higher costs, but they may also deal with lower sales.

Examples are legion in the consumer discretionary sector with weaker sales, earnings and margins for companies like McDonald's, Starbucks, Nike, Canadian Tire, etc. I'm not saying those companies will cut their dividend, but I'm saying the situation isn't all rainbows and unicorns.

Finally, keep in mind that CEOs aren't working for you. Their goal **is NOT** to make sure you retire happy.

CEOs want to protect their businesses and if this means cutting dividends, they will choose to amputate rather than lose the patient.

Don't be overly concerned as you can avoid most dividend cuts if you do your due diligence.

While CEOs don't sweat over your retirement and focus on their next bonus, DSR has your back.

I'd like to offer you my four favorite techniques to avoid those dividend cuts. They have all been proven to be highly effective in the past. Besides a few exceptions, we have been able to avoid most of the dividend cuts at DSR.

The following is a short, but most appropriate list of actions you should take with your portfolio this summer. There is nothing like hanging around a pool and optimizing your portfolio. The trading volume will be lower, volatility will take a pause, and it will be time for you to take a deep breath and make sure you don't suffer from dividend cuts this fall.

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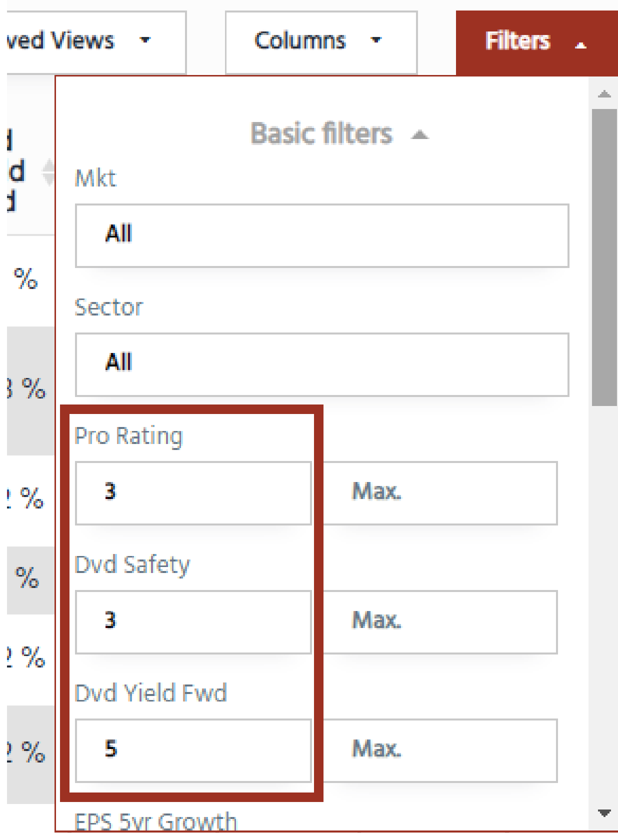
#1 Trust the market – beware of high dividend yield stocks.

My first indication that something may be wrong is usually the market action itself. While I don't rely on it, there is still some truth emanating from the action in the market. When a sector or most of the market follows the same movement, it's difficult to understand exactly what the market is telling us. However, when you see companies that are getting beaten down more than others, this is normally a sign that something is wrong.

If you have been reading my work for a while, you already know I'm not keen on high-yielding stocks. I've made a pretty compelling argument focusing on low-yield, high-growth stocks instead of high-yield, low growth ones in a previous newsletter called "Dividend Income for Life" (you can find it in the DSR fundamentals).

What's my definition of a high yield?

If I must draw a hard line, I'd say I consider a "high yield" to be above 5%. Off course, when the market crashes, many great companies will offer a 5%+ yield, but that's usually temporary and a great opportunity! In general, stocks with a yield above 5% often offer either a higher degree of risk, poor growth perspectives, or, most likely, both. Since I'm not looking for an immediate source of income, I don't have to bother with high-yielding stocks. However, whenever I hold a stock where the yield goes over 5% like Telus (T.TO / TU), I will pay more attention.



Not all high-yield stocks are bad investments. You will find some interesting picks in this category. A quick search using the DSR stock screener could help you build a list of decent high yield stocks. By selecting a minimum PRO rating and Dividend Safety Score of 3 (we want a stable company able to match or exceed the rate of inflation with its dividend growth rate) along with a minimum yield of 5%, you can find a list of about 153 stocks.

Here are a few examples on the next page.

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Data from DSR stock screener as of August 2nd, 2024.

Company name	Ticker	Sector	Yield	Pro Rating	Div Safety
BCE	BCE.TO / BCE	Communication	8.61%	3	3
Brookfield Renew.	BEP / BEPC	Utilities	5.05%	4	4
Brookfield Infra	BIP / BIP.UN.TO	Utilities	5.08%	4	4
BMO	BMO / BMO.TO	Financial	5.32%	4	4
Bristol-Myers	BMY	Healthcare	5.05%	3	3
Capital Power	CPX.TO	Utilities	6.11	4	4
CT REIT	CRT.UN.TO	REITs	6.19%	4	3
Emera	EMA.TO	Utilities	5.76%	4	3
Enbridge	ENB.TO / ENB	Energy	7.06%	3	3
Enterprise Products	EPD	Energy	7.28%	3	3
Great-West Life	GWO.TO	Financial	5.35%	4	4
Hannon Armstrong	HASI	Financials	5.07%	4	4
Labrador Iron Ore	LIF.TO	Basic Materials	14.34%	4	3
NNN REIT	NNN	REITs	5.53%	4	4
Realty Income	O	REITs	5.50%	4	3
Pfizer	PFE	Healthcare	5.50	4	3
Power Corp.	POW.TO	Financial	5.63%	4	4
Telus	T.TO / TU	Communication	6.98%	5	4
TC Energy	TRP.TO / TRP	Energy	6.61	3	3
Vici Properties	VICI	REITs	5.31	4	4

I must add a special mention for the many Canadian banks (CM, BNS, TD) that could have made the list, but it would have been redundant.

Important: even if they look good, high-yield stocks come with a high level of risk even after performing the appropriate due diligence.

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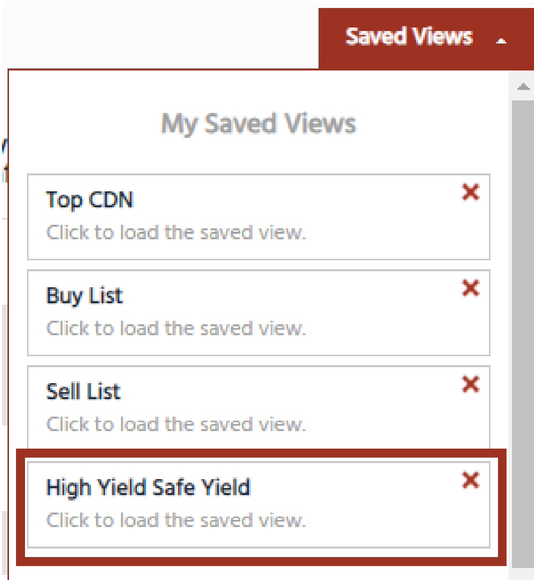

This is not an exhaustive list, but rather just a few examples of great companies offering a higher yield than the norm. This is a filter that you might want to save in your "saved views" if you are a DSR PRO member. It's worth looking at these companies from time to time.

The point here is not to completely avoid stocks with a yield greater than 5%, but rather not to concentrate your money into that type of higher risk holding. Remember that there is no free lunch in finance and investments. There are reasons why those companies are "so generous" with their dividends. One must follow those companies closely and make sure to review each quarterly report with great care and attention.

Note that many high-yielders don't generate much total return to their shareholders.

If you have high-yield stocks in your portfolio, here's a quick checklist

If you have stocks in your portfolio offering a yield above 5%, you might want to run through these quick checkpoints (more on some of them later in this newsletter).

- ✓ Has the company increased its dividend in the past 5 years?
- ✓ Is the dividend growth trend steady or slowing down?
- ✓ How are the payout ratios: above 100% or under control?
- ✓ What's the payout ratio trend?
- ✓ Is there an explanation for a high payout ratio? (Are you using the right calculation?)
- ✓ Is the business growing or struggling?
- ✓ How are their EPS and cash flow trends?

If you get mostly negative answers to those questions, you might want to take a deeper look into your analysis. To help you in this quest, we'll look at my trick #2 and #3.

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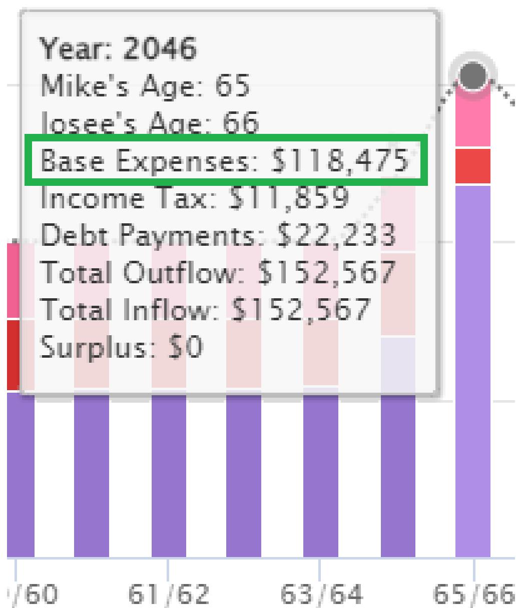
#2 Avoid stocks with an absence of dividend growth

As the inflation rate hasn't been excessive between 2010 and 2020, most income-seeking investors don't factor inflation into their investment decisions. Many told me, "*Mike, I'm retired, and I need this 8% income, I don't care about inflation*". I can understand that position if you have $1M invested at 8% and you only need $60k/year to live. This means inflation can eat up $20,000 per year in dividend income before it affects your lifestyle. That may make sense to some folk.

BUT… even a 2.1% inflation rate could be a killer.



As you know, I'm doing financial projections for DSR FI clients. Just for fun, I will show this example where, in 2046, I'll be 65. If I want to retire at 65 with a budget of $75,000 in today's dollars, I will need $118.5K at the age of 65 to keep the same lifestyle! At the age of 80, this means $161.8K with a small inflation rate of 2.10%!

Now, if your portfolio generates $75K in dividends today and doesn't increase, you know that you will have to make difficult choices as you age since your income will rapidly shrink.

This could also mean the difference between living in a comfortable senior home with all services and living in a basic government-sponsored healthcare facility.

I'm not here to be the fearmonger and tell you that we will go straight into a hyperinflation phase. But I'm here to tell you that even if central banks tame inflation (they seem to be on the right path), even a 2% inflation rate greatly affects your retirement plan.

Now, back to the "no dividend growth stocks". The problem is that many companies that keep their dividend static will eventually cut it. If management can't increase its payout when the economy is growing, what will happen during a crisis? You are correct – **they may be among the first to cut their dividend**. I tried to find companies where they were showing growing revenues and earnings but with no dividend increases over the past 5 years. They are rare. In fact, most "non-increasing" dividend-paying stocks will eventually look like this:

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Before telling me H&R REIT cut their dividend because of the covid-19 crisis, please keep in mind that the company also had to cut it back in 2009. In fact, this is pretty much a copy/paste scenario of the last crisis. In the early 2000's, the REIT grew for about 10 years and then cut its dividend by 50% to preserve the business. 10 years later, we see the same scenario evolving.

This tells you a lot about their business model. H&R is a classic "I look good on Prom Night" company. When the economy is doing well, and the market is rising it's like a wave. All the "trash" comes on top and it's nearly impossible to differentiate what looks like a fish or a bottle from the shore. Once you get closer and analyze the ocean, you realize the wave will bring in much trash once it crashes on the beach.

If you go back to your portfolio now and look for companies that have not consistently increased their payouts over the past 5 years, something is wrong. You might want to find out before it's too late.

"But Mike, that's good management to not increase a dividend during rough times".

My answer to this:

"It's also poor management to lead a company toward a struggling future. If the company can't afford to pay a higher dividend today, that's because it made multiple bad decisions over the past 5 years".

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You can double-check this affirmation with the Intel (INTC) or Walgreen (WBA) CEOs…

	VAL	CHG	% CHG
Intel Corp	20.04	-0.43	-2.10%
Walgreens Boots Alliance Inc	10.60	+0.04	+0.38%

	VAL
Intel Corp Dividend	0.125
Walgreens Boots Alliance Inc Dividend	0.25

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It's time to act now and look at which holdings would do a better job with what is left of your capital. Don't wait for the full recovery as it may be a painful path that will only lead to more losses. Both the Canadian and the U.S. markets have more than recovered already. Companies that have not recovered have been left behind as their flaws have been exposed.

Hope is a terrible strategy.

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#3 Weak dividend triangle

You know that by now the dividend triangle is a very strong indicator when it comes to assessing the likelihood of a dividend cut. The Dividend Triangle is composed of three metrics.

Revenues: A business is not a business without revenues. What is the difference between a company making growing revenues versus a company showing stagnating results? We are looking for companies with several growth vectors that will ensure consistent sales increases year after year. I'm a big believer in "offense is the best defense". Whenever we are about to face a recession, I want to make sure I have companies that have shown past revenue growth. This is an excellent indicator that their business model is doing well, and they don't enter a recession in a position of weakness.

Earnings: You cannot pay dividends if you don't earn profits. If earnings don't grow consistently there is no point of assuming that the dividend payment will increase indefinitely. Keep in mind that the EPS is based on a GAAP calculation. This is what makes EPS imperfect, as accounting principles are not aligned directly with cash flow. This means you are better off looking at the EPS trend over 3, 5, and 10 years. Use an adjusted EPS that takes off those one-time events revealed by the company to have a clear view of what is happening. Some companies "play around" with earnings for a year or two, but you can't create a trend out of thin air.

Dividends: Finally, dividend payments are the *obvious* backbone of any dividend growth investing strategy. But I don't focus on the real dollar amounts or the yield. I focus solely on dividend growth. Dividend growers show confidence in their business model. This is a statement claiming that the company has enough money to both grow their business and reward shareholders at the same time. This also tells you that the business can pay off its financial obligations and invest in new projects (CAPEX). No management team will increase their dividend if they lack the cash to run their business.

Companies losing market share due to the lack of competitive advantages will see their story through their revenue trends. It is very rare to see a business reporting growing revenues year after year. For many reasons, a company could publish weaker results. It could be the end of a cycle, a change in the business model, or simply the economy slowing down. However, if this situation persists for several years and management can't find growth vectors, the red flag must be thrown.

The same logic applies to earnings. Since earnings calculations are based on GAAP, we are not talking exclusively about real money. This number is far from being perfect. In fact, you are better off combining it with free cash flow or cash flow from operations to see what is really happening inside a company. Nonetheless, if a company is unable to generate growing EPS over a long period of time (5 to 10 years), chances are dividend growth will not happen either.

Finally, as I discussed earlier in this newsletter, a lack of dividend growth is a sign there is a problem that must be investigated. When management is confident enough to raise their payouts by 4-5% or more each year, I can sleep well at night, and I really don't mind what is happening in the market. Sooner or later, the market will bounce back, and the dividend growers are the companies that will thrive.

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DIVIDEND SAFETY SCORE & EXAMPLES

If you follow your stocks quarter after quarter and you keep only those who show consistent dividend increases, you will surely avoid most of the dividend cutters. The next step is to focus on those companies that show a strong dividend triangle, and your portfolio should get much healthier within a comparatively short period of time. To refresh your memory and provide additional explanation, I thought we should look closely at a real example for each dividend safety score.

Dividend Safety Score definition

As opposed to many other services, my definition of a dividend safety score differs. Most financial services will define dividend safety by the likelihood of this dividend not being cut. Therefore, a "safe dividend" is a dividend that is not likely to get cut but could stay the same for several years.

This is where I differ.

In my opinion, a dividend that doesn't increase is not a safe dividend and deserves poor scoring.

By definition, a stable dividend over 5 years has contributed to decreasing your buying power…

Every

Single

Year.

If your buying power decreases, you suffered from a "passive dividend cut". Therefore, the dividend isn't safe.

Given my preference for dividend growers, I've established my dividend safety scores as follows:

5 = **Stellar dividend** - Past, present, and future dividend growth looks impressive.
4 = **Good dividend** - The company shows sustainable dividend growth.
3 = **Decent dividend** - Don't expect much more than 3-5% dividend growth.
2 = **Dividend is safe but** - Not likely to increase this year (0-3%). Potential for a dividend cut.
1 = **Dividend Trash** - There has been a cut, or the dividend is not sustainable.

The following pages will provide you with past or present examples of each scoring.

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Dividend Safety Score of 1: Dividend Trash – Hanesbrands (HBI)

This an interesting example that I decided to keep as it was rated with a dividend safety score of 2 in 2022, Then, the company suspended its dividend at the end of 2022.

As you can see on the graph, HBI has never been able to recover from the pandemic. Before 2020, everything was stable, but the company was already showing signs of weakness and had no dividend growth. After the pandemic, the company hasn't been able to generate stronger revenue and earnings and eventually fell off the wagon.

What was left to do? Taking an axe and swinging at the dividend payments.

I also wanted to keep this example to show you that, once again, hope is a terrible strategy. Those who kept HBI past 2022 made a terrible decision as no money was recovered. Plus, imagine how the money could have been invested in low yield, high dividend growth stocks instead.

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Dividend Safety Score of 2: Dividend is safe but…

The safety score of “2” is a little bit tricky. By default, you will find all these stocks with no or minimal dividend increases. A classic example would be Transcontinental (TCL.B.TO):

I’ve been asked several times about my thoughts on Transcontinental during webinars. My answer has always been the same: this is a dying business trying to make a significant business model shift.

Yeah Mike, but what about the yield?

This is exactly the type of reflection that will hurt your portfolio. TCL shows no signs of growth, and the EPS is going downhill for the past 5 years. Are you really surprised to see the same dividend payment since 2020?

To get paid by TCL, you accept holding shares of a struggling company showing weak fundamentals. I expect I’ll use TCL as an example next year too… but, it will be to show you a Dividend Safety Score of 1.

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However, there is another context that could generate a dividend safety score of “2”. This could be a company focusing on growth and ignoring their dividend. In this case, the dividend is safe, but don’t expect a dividend increase. However, the company is healthy and could still bring great returns in your portfolio. WSP Global (WSP.TO) is a great example of such a business. You can clearly see that this engineering firm could offer a higher dividend payment, but management finds more value in keeping the money inside the business. I can’t really argue with that decision.

In general, our DSR investors should minimize the number of their holdings with a rating of “2” in their portfolio. Those are great candidates for a dividend cut. The best-case scenario for these companies is no dividend growth. The worst case is a loss of capital due to a share price decline followed by or caused by a dividend cut.

As shown with the WSP example, it is also possible to have a few “2’s” in your portfolio which will do just fine. The key when you have a “2” in your portfolio is to look at the dividend triangle and understand why the company doesn’t increase its dividend. For Hanesbrands, it’s clear the company is struggling. For WSP Global, it’s clear the company is thriving but has preferred to keep cash flow to boost the business instead of boosting distributions. It’s all about obtaining a good balance. Other examples I could think of are Constellation Software (CSU.TO), Canadian Pacific (CP.TO) and Gentex (GNTX).

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Dividend Safety Score of 3: Decent Dividend

A decent dividend often means the company will continue to increase its dividend, but to expect a low to mid-single digit growth rate going forward. This means the dividend is safe and you can expect the dividend revenue will match/beat normal inflation. This is often the case when you look at utilities and good REITs such as Duke Energy (DUK), Emera (EMA.TO), Consolidated Edison (ED), Realty Income (O) or CT REIT (CRT.UN.TO).

Some companies have lost their dividend safety score of 4 in the past three years and received a rating of 3. This means they will preserve their dividend growth streak but likely will not be able to keep up with their previous generous rate of dividend increases. A good example would be Magna International (MG.TO / MGA). The company's dividend increased by 63% between 2017 and 2022. However, the latest dividend increases were only 2% (2023) and 3.26% (2024). Like many other companies, Magna International is dealing with shrinking margins mostly due to high inflation and higher interest rates.

Such a company could get back its rating of 4 as soon as it starts showing a stronger dividend triangle. Don't forget that we review our dividend ratings quarterly. Nonetheless, you can sleep well at night with most of your 3 rated companies. A quarterly monitoring and due diligence, however, are always required.

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Dividend Safety Score of 4: Good Dividend

A good dividend is earned by a company able to increase its dividend by more than 5% year after year. You can find many classic dividend growers in this category.

	VAL
Johnson & Johnson Dividend % Change	30.53%
Royal Bank of Canada Dividend % Change	35.24%
TELUS Corp Dividend % Change	38.35%
Lockheed Martin Corp Dividend % Change	43.18%

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In some cases, the growth rate may be smaller, but the company will show a long history of dividend payments along with a solid business model. A good example would be Colgate-Palmolive (CL) with 60 consecutive years of dividend increases. You can surely imagine that this business will sail through the current recession without significant difficulties. The safety score is not only about growth. It is also about peace of mind.

You could also find crazy dividend increases over the past 5 years such as Canadian Natural Resources (CQN) or Broadcom (AVGO) with 180% and 98% dividend increases, respectively. They don't have a rating of 5 since we don't believe their double-digit dividend growth rate is sustainable.

In other words, when you select dividend stocks with a rating of 4, you can expect generous and steady dividend increases. The companies in this category are generally amazing enterprises.

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Dividend Safety Score of 5: Stellar Dividend

A stellar dividend will usually show a high single-digit to double-digit dividend growth rate. In this turbulent market, we won't find many qualified candidates. One great example is Microsoft (MSFT) as the company is already on a strong growth path but is also built to thrive in all kinds of situations.

It's hard to get a dividend safety score of 5 at DSR. Only 6 companies have this mention right now.

Alimentation Couche-Tard (ATD.TO), American States Water (AWR), Home Depot (HD), Microsoft (MSFT) Mastercard (MA) and Visa (V).

We'd rather be on the "safe side" and not give 5-ratings like candy instead of playing ping-pong with ratings.

However, now that we are in the middle of this complex economic environment, we will "graduate" a few more companies to a 5 rating by the end of the year. Some companies deserve that better recognition.

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Final Thought: the dividend safety score is not set in stone

As you can readily imagine, a company's dividend safety score will potentially evolve over time. We consider the company's metrics and business model, but we also consider outside elements such as the state of the economy and the overall environment. In 2019, we had a flourishing economy, and many companies were showing scores of 5. We also showed smaller numbers of ones and twos.

In the end, the score is more like a shortcut telling you upfront what to expect. Further due diligence is required prior to making any trades. **Using ratings is a good starting point for your research, but one should never trade on a scorecard.**

I personally use the scoring system in first search using the DSR screener. However, I will **never buy or sell a stock based on its rating.** There is nothing better than a good qualitative analysis before pulling the trigger.

Companies showing 3+ for both their PRO rating and their dividend safety scores are the strongest companies according to our model. The recipe for a healthy portfolio is often a mix of sector allocation and selecting holdings showing robust financial metrics and a strong balance sheet.

If you ever have questions about dividend safety scores, I'm always just an email away.

Cheers,

Mike

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