DSR PREMIUM NEWSLETTER

IN THIS ISSUE…

- Performing high-yield stocks
- Dividend traps vs deluxe bonds
- Careful with dividend cuts

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OCTOBER 20TH, 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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DIVIDEND STOCKS ROCK

INVEST WITH CONVICTION, ENJOY YOUR RETIREMENT

HIGH YIELD: DIVIDEND TRAPS, DELUXE BONDS and DIVIDEND CUTS

After writing so much about low-yield, high-growth stocks, I thought I should offer a newsletter about high-yield stocks. To be fair, they are not all bad investments. Some companies provide a source of high income that is fairly sustainable for investors. Having a few in your portfolio may be a good idea.

I'll start this newsletter by giving my thoughts on 21 performing high-yield stocks. Then, we'll discuss the difference between a "dividend trap" and what I call a "deluxe bond". I just cannot help myself and will discuss the potential of future dividend cuts as a closing remark. Remember: many struggling companies see their stock price decline while providing a higher yield before there is a dreadful dividend cut.

But let's start with a positive: some stocks are both providing a high yield and outperforming the market!

HIGH YIELD THAT KEEPS ON GIVING

I went on a hunt to find companies with at least a 6% yield that have matched the overall stock market performance of late. On October 7th, the iShares S&P/TSX 60 ETF (XIU.TO) 5-year total return (capital + dividends) was about 52% and the SPDR S&P 500 ETF Trust (SPY) was about 74%. My research included all companies generating a total return of at least 50%. That list included 101 stocks. I won't go through all 101 in this newsletter, but I wanted to share some thoughts on 21 of them to give you a sense of what is good and what is not good from that list.

Please note that they are in alphabetical order, and I wouldn't normally invest in any of these securities, although some of them are quite attractive. Please proceed with caution and do your due diligence first!

AllianceBernstein (AB) 8.55% yield, +63.93%

AllianceBernstein is an asset manager providing investment products to institutional investors (45% of assets under management), retail investors (39%), and private clients (16%). AB isn't one of the largest asset managers with ~$700B in assets under management (38% in fixed income, 43% in equity + various strategies for the remaining). It's past 5 years performance is mostly due to its variable dividend payments. If you go with AB, you'll get a dividend payment that will go up and down depending on how much AB is making in profit. This is a conservative way to pay only "what AB can afford", but it makes it difficult for investors to plan their future income. If I was to invest in an asset manager, I would choose one with more stable numbers. Please note that AB's dividend triangle is seriously weakening since early 2022.

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Arbor Realty Trust (ABR) 11.28% yield, +107.2%

ABR is probably the only mortgage REIT that is worthy of consideration. Most mREITs fail their shareholders with dividend cuts or no dividend growth. ABR has been a good performer over the past 10 years and shows consistent dividend growth. If you look at their dividend triangle, you might think it's not actually a mREIT! While the company's interest rate spread is shrinking, ABR is still generating positive cash flow and compensates with an aggressive loan origination program. The company's success seems to be a combination of a few factors: a strong and experienced management team, bridge financing which makes it easier to match interest rate fluctuations, a robust balance sheet, and an aggressive loan origination policy to compensate for weaker interest margins. The ABR stock price remains relatively stable over time and the dividend keeps increasing.

AGF Management (AGF.B.TO) 6.22% yield, +64.88%

I was surprised to see this Canadian asset manager outperforming the TSX over the past 5 years. Interestingly, the company has managed to generate higher revenue and EPS since 2021. This coincides with three dividend increases since 2021! AGF manages a little over $40B in assets under management. It is a small player in an ocean of big fish. Also, keep in mind that AGF is a small capitalization ($440M) that could see its stock price go up or down in a heartbeat (hello volatility!). The company used the sale of its stake in Smith & Williamson to buy back shares and pay down debt. It also focuses on acquiring talent to ensure better fund performance. For a company like AGF, performance is everything. It seems like a risky play considering the size of the company vs. the bigger players. Don't forget that AGF cut its dividend as recently as 2015.

Ares Capital (ARCC) 9.94% yield, +90.28%

At DSR, we aren't fans of high-yielding stocks. However, ARCC successfully survived the 2008 financial crisis. It did so with a dividend cut but managed to build back a solid business and did this again in early 2020 when ARCC was priced for a dividend cut. As the economy recovered, ARCC increased its dividend by $0.01 in the summer of 2021. If you look at their dividend triangle, you'll see a strange line for the dividend. It's because the company pays an extra $0.03/share on top of the quarterly dividend. Although ARCC is a solid BDC, keep in mind that the only return an investor will receive from this company is its dividend payment. Higher interest rates will mean higher revenue for ARCC, but it could also mean a higher default rate on loans they hold. The new economic environment may not be favorable for ARCC to increase its dividend.

Birchcliff Energy (BIR.TO) 10.15%, +98.89%

If you want to jump onto a roller coaster, you have found your ride with Birchcliff Energy. BIR.TO jumps up and down depending on commodity prices. This is what happens with most drilling companies. BIR.TO went from less than a dollar per share in 2020 to $12/share in 2022. However, if you bought on the uptrend, you are now disappointed as BIR.TO now trades slightly lower than $8 and its dividend triangle is weakening once again. Keep in mind that BIR.TO once traded above $14 back in 2014.

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Capital Power (CPX.TO) 6.03%, +89.62%

Capital Power was a market darling not too long ago as its stock price defied gravity while other utilities were going down. While the market has some reservations about utilities (this sector is interest rate sensitive), CPX continues to show a relatively strong dividend triangle. Management also recently increased the dividend from $0.58/share to $0.615/share. A 6% dividend increase in the middle of an “interest rate crisis” is a bold move showing strong confidence. Management reaffirmed its dividend growth policy rate of 6% through 2026.

Cross Timbers Royalty Trust (CRT) 10.78% yield, +106.1%

Small cap alert! CRT shows a market cap of $120M and offers a variable dividend based on royalties the trust generates. The Trust saw its revenue and profit rise as CRT earns oil and gas royalties from properties in Texas, Oklahoma, and New Mexico. While now it looks like CRT is an amazing investment, keep in mind that royalties follow commodity price fluctuations, and so, in turn, do the dividends.

Doman Building Materials Group Ltd (DBM.TO) 7.39% yield, +136.2%

DBM is a wholesale distributor of building materials and home renovation products. While it offers a yield around 7%, I think it’s the perfect example of a company that showed great metrics with revenue and EPS rising over the “covid hype” but won’t be as successful in the future. We can already see revenue (and mostly EPS) going down since 2022. DBM surfed on the “covid hype”, but we can see demand slowing down as the construction industry will face a recession due to higher interest rates. Keep in mind the dividend paid today is the same that was paid 10 years ago… Not to mention that DBM is a small cap ($650M).

Enbridge (ENB.TO), 7.90% yield, +50.20%

I smiled when I saw the total return of 50% on Enbridge as it reminded me that I bought it in 2017 and sold it at the beginning of this year to show a good profit. ENB is a good example of a deluxe bond (more about that later in this newsletter) but could eventually evolve into a dividend trap! The weight of interest charges will continue to be a problem as the company can’t find any growth vectors without getting into more debt. The company operates high-quality assets and its barriers to entry are almost impenetrable. There is no doubt the business model is solid. The problem is the debt level that keeps on going up. ENB won’t be able to rely on its pristine pipelines forever.

First National Financial Corp (FN.TO) 6.68% yield, +99.76%

In an environment where many economists are concerned about the housing market in Canada, it may not be very intuitive to invest in a mortgage underwriter. However, FN has proven it can do well in troubled waters. Its key advantage is that of being the first mover in the digital lending world. We were skeptical at first, but the last three years of performance have convinced us that there is enough room for FN to grow alongside the Canadian banks. FN is great for income-seeking investors with a high yield and an annual special dividend that brings the total dividend yield even higher. It doesn’t mean you can close your eyes and not monitor this one.

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Freehold Royalties (FRU.TO), 7.51% yield, +88.41%

Freehold Royalties is an interesting play in the oil & gas industry. I like the business model of acquiring royalties as FRU is literally buying cash flow generating assets. However, it doesn't mean their model is bullet-proof. The company is a famous dividend cutter (three times between 2014 and 2016 and again in 2020). Its ability to pay dividends will also depend on commodity price fluctuations. FRU increased its dividend several time since 2020, but it still doesn't pay as much as it used to in 2014 ($0.14/share vs. $0.09/share today). It's worth mentioning that the last dividend increase happened in 2022. Nothing so far in 2023 as the dividend triangle is weakening once again.

Gladstone Capital Corp (GLAD) 10.37% yield, +59.84%

Investment companies in the U.S. are known to be quite generous with their dividends. GLAD offers a 10% yield, but keep in mind that the dividend has remained the same for 10 years and was temporarily cut during the pandemic. The dividend payment is now higher than ever at $0.083/share (but don't bet on another dividend increase anytime soon). GLAD invests in debt securities of established businesses that provide stable earnings. As interest rates increase, GLAD's net income should rise accordingly. The biggest risk is GLAD's ability to handle a recession. I'm betting on a dividend cut if the predicted recession ever happens.

Innovative Industrial Properties (IIPR), 9.47% yield, +118.70%

Are you surprised to see this company on the list? While the IIPR stock price has dropped by more than 70% since its peak in 2021, the stock was trading around $40 per share 5 years ago. The company is facing several headwinds (short-seller theory on IIPR financing tenants through higher rent, trouble collecting from a tenant, etc.). IIPR increased its dividend by 3% in September of 2022 but nothing since then. While the market is being the market, IIPR continues to acquire facilities and the CEO tries to shift the narrative. Revenue has kept increasing so far, but the dividend hasn't been raised in 2023 and the REIT is using safety deposits to cover some rent payments.

KP Tissue (KPT.TO), 7.25% yield, +59.22%

KP Tissue is a great example of a company that looks like a good investment (**BUT IS NOT**). KPT sells essential products with recurring purchases (bathroom and facial tissues, paper towels, napkins, etc.). Its total return outperformed the TSX over the past 5 years. However, the company's dividend triangle is in bad shape and the dividend has not increased over the past 10 years. This screams for a dividend cut! On top of that, KPT is an "ultra" small cap with an enterprise value under $100M.

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Labrador Iron Ore Royalty Corp (LIF.TO) 8.89% yield, +101.4%

LIF has a great business model. It receives a 7% gross overriding royalty on iron ore products produced and sold by Iron Ore Company of Canada, a North American producer and exporter of iron ore pellets and high-grade concentrates. The mine enjoys a high-quality source of products with sufficient inventory to support future expansion. The high quality of the iron ore and ability to produce higher margin pellets positions IOC well strategically. LIF pays a variable dividend ($0.25/share quarterly + a special dividend based on earnings). You can't count on receiving a stable dividend, but LIF's yield is usually in the high single-digit to low double-digit range. Demand for iron ore will come and go, affecting its price, and, therefore their dividend payments. It's not a bad investment if you are able to stomach the price and dividend fluctuations (that dances a tango with the iron ore price).

Main Street Capital (MAIN), 7.80% yield, +58.62%

MAIN pays a monthly dividend providing an ~7% yield and has used a special dividend payment annually to sweeten the deal for its investors. MAIN skipped the special dividend for a few years following the Covid crash but paid one in 2023. This BDC is among the most respected and well-run businesses in its industry. The company has never failed shareholders and demonstrates a meticulous underwriting process to avoid bad loans. Overall, MAIN pays a generous dividend and still increases its net asset value (NAV) per share on a consistent basis. The BDC also performed well during the financial crisis of 2008. We have never been fond of BDCs as they always only appear to be fine during economic booms, but MAIN seems to be in its own class.

MCAN Financial Group (MKP.TO), 9.75% yield, +101.2%

The Company's objective is to generate a reliable stream of income by investing in a diversified portfolio of Canadian mortgages, including residential, residential construction, non-residential construction, and commercial loans. MKP doesn't get much love at DSR due to its hectic dividend triangle. MCAN shows revenue, EPS and dividend growth over the past 2 years, but keep in mind that the company cut its dividend at the end of 2018. Higher interest rates are a blessing and a curse at the same time. Right now, it means more revenue and earnings for MCAN. In a year from now, maybe consumers will have a hard time dealing with higher payments. It's doing well so far but proceed with caution.

Oaktree Specialty Lending Corp (OCSL), 11.79% yield, +121.30%

Most BDCs (Business Development Companies) appeared on the market after the 2008 financial crisis. Oaktree hasn't always fulfilled its promises in the past (dividend cuts in 2015 and 2017), but it is currently on a strong dividend growth trend since 2019. Is it sustainable? I don't think so. Since OCSL cut its dividend when things got sour in the past, I don't think management will hesitate to do it again in the future. There is a reason why OCSL now offers an 11% yield. I'm concerned about the impact of the coming recession on all those debt repayments. Things can go sour quickly in the credit world.

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Pizza Pizza Royalty (PZA.TO), 6.74% yield, +116.9%

Pizza Pizza used the covid excuse to cut its dividend and get on more solid ground. Since then, the dividend has been fully restored and the pizza company even increased it more than its 2019 level (now $0.075/share). While the dividend triangle shows great strength since 2021, I remain sceptical about PZA's growth potential moving forward. We'll see if the company can keep up its growth pace. Keep in mind the 5-year annualized growth rate is still quite low (0.45% for revenue, 0.20% for EPS and 0.35% for dividend).

SPECIAL MENTION Canoe EIT Income Fund (EIT.UN.TO) 8.70% yield, +91.34%

While it's not a stock but rather a closed-end fund, I wanted to mention Canoe EIT income fund in this newsletter. It was fully reviewed in September in the "Cash flow newsletter". The fund manager made a bet on energy in late 2020, and it paid off. EIT has beaten its benchmarks for the past 10 years.

Canoe EIT income fund is not the worst investment in the world. In fact, it generated decent returns considering its dividend. While recent performance on the market is impressive, the fund is not perfect. First, they cannot avoid fluctuations when the market is shaky. If you looked at your portfolio value during corrections, Canoe did not save you from headaches.

DIVIDEND TRAPS Vs DELUXE BONDS

A shoutout to Denice, a DSR member since 2020, who asked to have a list of deluxe bonds.

I invented the term "deluxe bond" for companies where I don't expect much capital appreciation but where the yield is good (above 4%) and the dividend growth policy is enough to keep inflation in check. A "real" bond would give a high yield with no growth while a "deluxe bond" should be a mature business that still generates enough growth to qualify as a dividend grower.

To create that list, I've used the DSR stock screener with the following metrics:

- PRO rating minimum of 3
- Dividend Safety Score minimum of 3
- Yield minimum of 4
- Revenue growth 5-yr minimum of 1%
- EPS growth 5-yr minimum of 1%
- Dividend growth 5-yr minimum of 3%
- Chowder score minimum of 8

Those screen criteria created a list of 23 Canadian and 74 U.S. stocks with some duplicates due to companies trading on both markets. There were 28 and 85 companies a year ago, respectively. This short list of stocks would show all companies with a relatively high yield (4%+) that show minimum growth and a respectable dividend triangle.

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To improve your research, I would suggest cutting all companies with a market cap under $2B to avoid fluctuations (by definition, they couldn't bring the peace of mind "deluxe bonds" offer). You can also increase the minimum PRO rating to 4 as you would narrow down your research to a total of less than 50 companies. Among this list, here are some of my favorites:

Canada

Canadian banks fit the bill as they provide both revenue and growth. BNS and CM are closer to deluxe bonds (less growth perspective, higher yield), but any banks could be placed in that category right now due to their generous dividend yields.

Telecoms are also another classic example although I prefer **Telus (T.TO)** by a wide margin.

You can't forget pipelines either. **Enbridge (ENB.TO) and TC Energy (TRP.TO)** are not known to generate double-digit returns, but they will not fail on making generous dividend payments regularly. In the energy sector, there is also **Canadian Natural Resources (CNQ.TO)** that offers a yield barely above 4%.

Labrador Iron Ore (LIF.TO) which was already mentioned in this newsletter would fit the bill for a deluxe bond as well. It comes with a bit more volatility, but it certainly has provided investors with some solid dividends in the past.

With the recent drop in price, some utilities appeared on that list too! **Fortis (FTS.TO)** and **Emera (EMA.TO)** are great companies that recently reaffirmed the dividend growth policy through 2026.

U.S.

If we ignore Canadian companies, the list of interesting Deluxe Bonds in the US is quite short. You will surely find a bunch of regional banks and energy stocks, but I see them more as speculative plays.

Target (TGT) now makes the list as its yield is now around 4%. TGT lost more than half of its market valuation from its peak in 2022. I didn't understand the previous hype and it seems the market came back to its senses. TGT will continue to grow inside the US, but don't expect much growth here.

UPS (UPS) is another one that recently joined the 4% club. The company will most certainly face some headwinds and serious competition going forward. But their dividend is definitely safe.

Realty Income (O) and **NNN REIT (NNN)** with yields of 6.1% and 6.4% can be interesting if you want to increase your exposure to REITs.

Additional note on deluxe bonds

When I use the term "deluxe bond" I want to illustrate a company with a poor stock price appreciation potential with a decent yield (above 4%) and a minimal dividend growth policy (at least 3%). However, the wind could quickly turn, and those deluxe bonds could rapidly become dividend traps…

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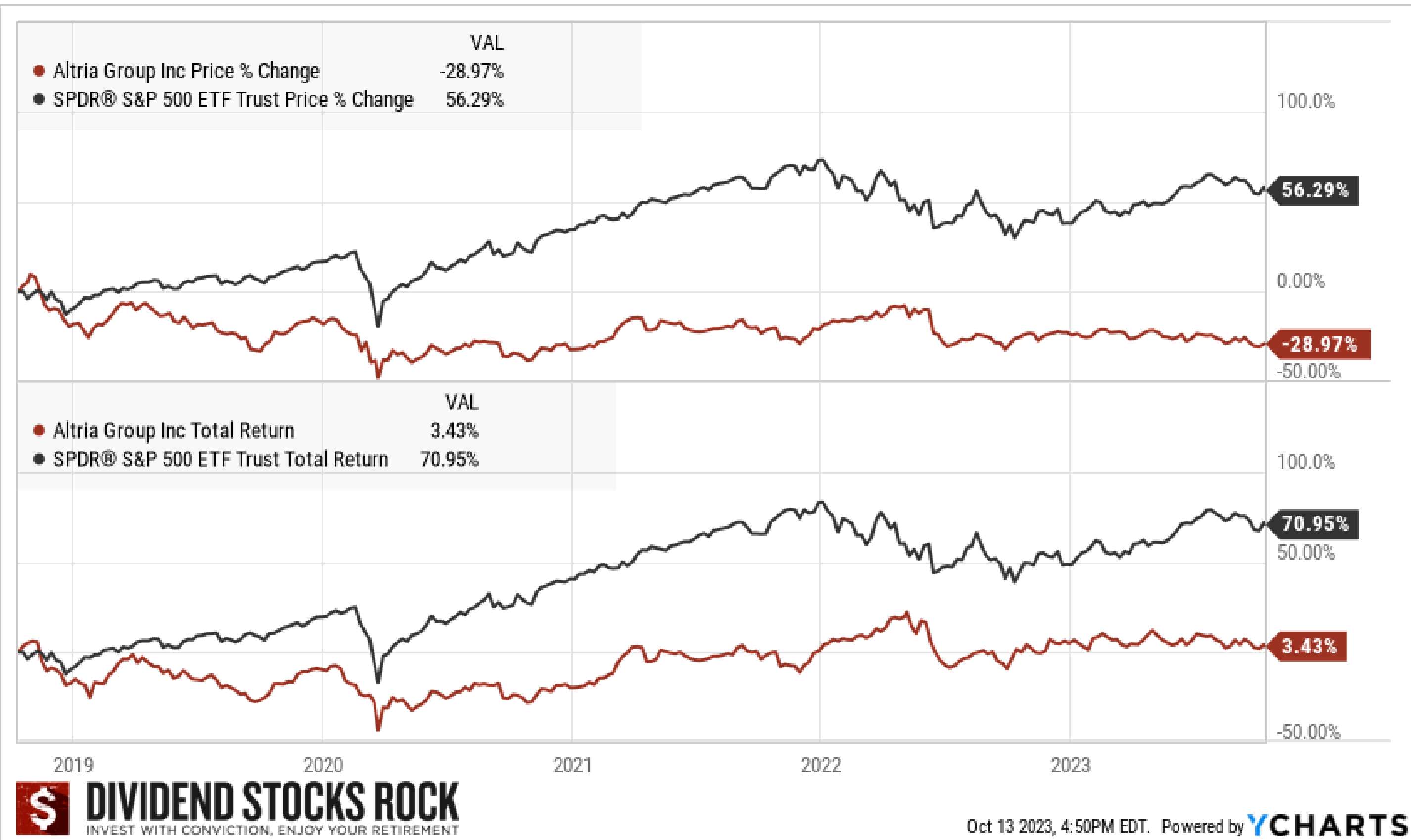
What's a Dividend Trap?

A dividend trap is a stock that has nothing to offer besides its yield. Most of the time, the company fails to generate total return, but income-seeking investors turn a blind eye to this aspect and focus on their dividends. In other words, the stock price declines but as long as the dividend is paid, investors keep smiling. The most pernicious traps are the ones with no dividend cuts or even a dividend increase to keep the hope up. Think of a stock like Altria (MO). Many investors like to say, "*Mo money*", but are they really getting more? I'll let you decide:



Over the past 5 years, the stock price lost almost 30%. However, when you consider the dividend, MO's total return comes back to positive territory at 3.4%. You may be tempted to say it's "okay" since you didn't lose money. However, if you had decided to invest in the S&P 500 instead, you would be up 71%. That's a costly choice in my opinion.

If you want to identify a dividend trap, you can start by looking at your high-yield stocks and consider their dividend triangle. Also, consider your investment thesis. If the word "yield" is part of your thesis, you are on the right track to identify the trap.

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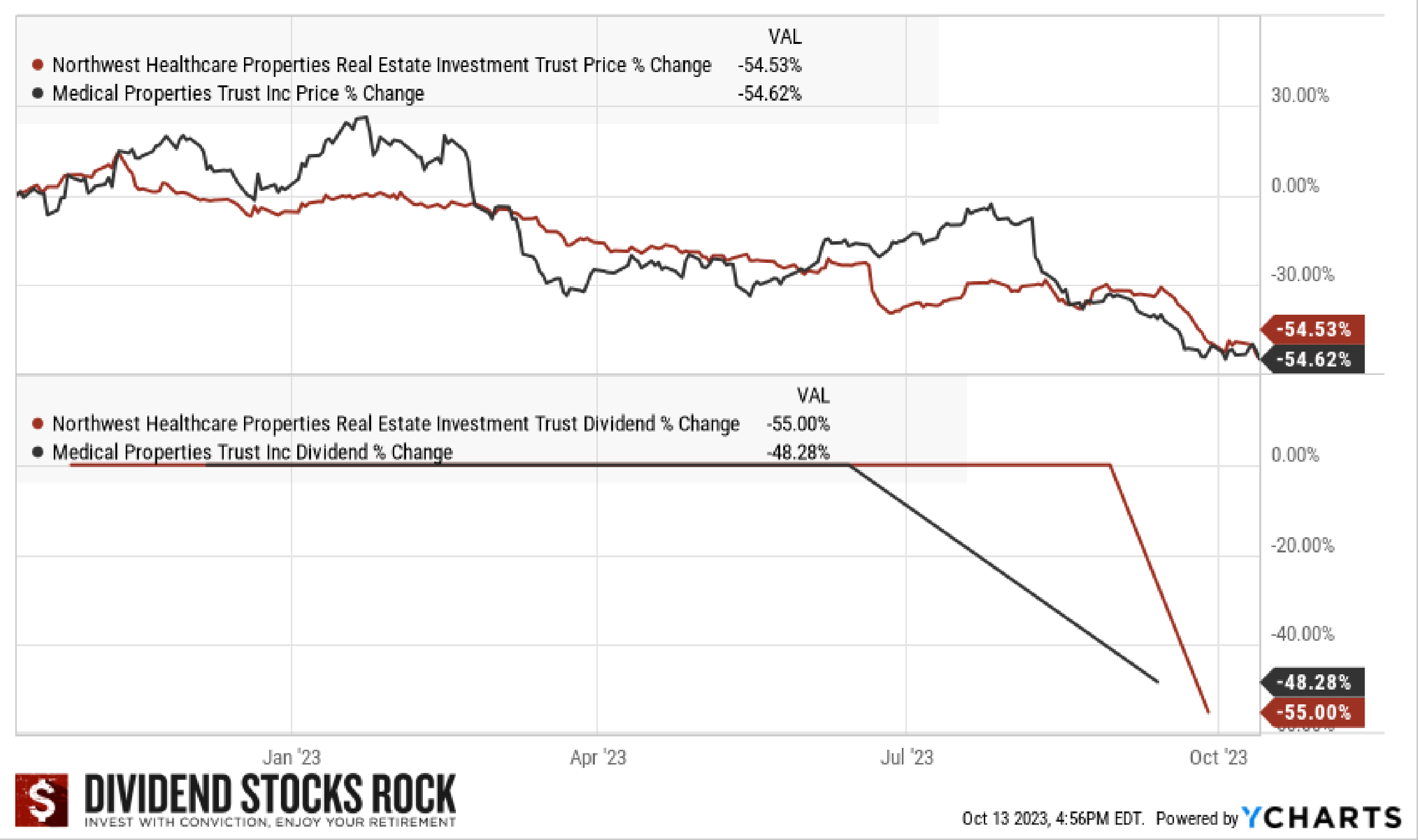
CAREFUL WITH DIVIDEND CUTS

I cannot say it enough: high-yield stocks are prone to dividend cuts. Each time it happens, it comes with a double impact:

- ✓ Loss of income (dividend cut)
- ✓ Loss of capital (stock price decline)

In February of 2023, we announced the sale of our shares of Medical Properties (MPW) in our DSR portfolio to "be on the safe side". In August, the company announced a dividend cut. Shareholders lost about half of their investment (-55% ytd) and 48% of their income. We warned members several times about the poor quality of Northwest Healthcare Properties (NWH.UN.TO). The REIT cut its distribution and shareholders were left with a 55% loss on both sides (income and capital!)



Dividend cuts have a catastrophic impact on your portfolio. It could even cripple your retirement plan.

You can't avoid all dividend cuts, but you can prevent most of them and also minimize the impact of each cut on your portfolio.

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Guide to avoid dividend cuts

Here's a quick checklist to avoid dividend cuts amongst your generous payers:

1. **Make sure your investment thesis is backed by numbers**

   A story about why you love a stock is great, but having numbers in line with your story is a lot better.

2. **Get rid of stocks with a poor dividend triangle**

   A high yield with no revenue, EPS growth, or dividend growth can't stay in your portfolio.

3. **Avoid high payout ratios**

   If payout ratios are around or above 100%, it's time to run.

4. **Minimize the weight of your high-yield stocks**

   Review your stock weight and dividend income weight using the DSR PRO dashboard to diversify your portfolio and your sources of income.

5. **Do not have too many stocks in the same sector or with the same business model**

   If you have 4 office REITs, you have exposed yourself to major damage in your portfolio

6. **Avoid a concentration into interest rate sensitive sectors**

   Capital intensive businesses (read heavy investments in projects) are more exposed to higher interest rates. They will be the first ones to fail their shareholders.

FINAL THOUGHTS

As the market has dropped in 2022 and is now quite volatile in 2023, most dividends are still alive (and growing), and many companies now offer a yield above 4%. This is a great opportunity to invest more money or simply make sure to reinvest your dividends in money-printing machines.

This doesn't mean you should pick anything that shows a good dividend triangle and a decent yield. When looking at metrics, ask yourself if the past 3-5 years of financial performance have a good chance to be replicated over the next 5 years. Some companies just surfed on a temporary tailwind while others have been around for a long time and have a proven business model. You want to pick from among the latter group of companies.

Cheers,

Mike.

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