DSR PREMIUM NEWSLETTER

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FEBRUARY 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.**

DO YOU KNOW YOUR SECTORS?

I could probably write an entire book on sectors, but that would be an unnecessary mountain of knowledge to climb for anyone attempting to read it. Plus, you don't need a book to understand how each sector works. What you need is a clear analysis guideline that will tell you what is important to know and how to make the best investment decisions with that knowledge. Each of the following sector reviews will start with a brief description of the sector. This will set the table for the rest of the analysis. We will cover the following points:

Sub-Sectors (Industry)

This section will include a list of all the sub-sectors of what will be named "industry" in our upcoming stock screener. An investment sector will group many different companies. They will then all be regrouped into industries as they share many characteristics. If you are overexposed to a sector (e.g., over 20% of your portfolio), but you invested in different industries, you may still be well diversified. For example, you may have a company in aerospace & defense, one in building products, another one in railroads, and a fourth in tools and accessories. They are all part of the industrial sector, but the building products have little to nothing to do with the defense industry.

Greatest strengths

We will highlight what investors like most about each sector. Is it growth or stability or predictability? Each sector is different and offers its own unique opportunities.

Greatest weaknesses

Unfortunately, nothing is perfect. Each sector has its strengths, but also has its weaknesses as well. Understanding those weaknesses will help you manage fluctuations and optimize the risk within your portfolio.

How to get the best of it

After combining strengths and weaknesses, we will show you how to position your portfolio to benefit from each sector. For example, most industrial stocks are cyclical. There are times when you can enter or increase your position in this sector to show stronger returns. **This goes on top of the regular DSR analysis process and the dividend triangle.**

Favorite Picks

I'll have a short list of my favorite picks in each sector. Those are not necessarily "buy recommendations" and I'm not looking at the current price before adding them as my "favorites". Most of the time, you will recognize the names of stocks in my portfolio or in any of the DSR portfolios. The point is to give you an idea of what we like. Then, it will be up to you to determine which stocks are best for your portfolio.

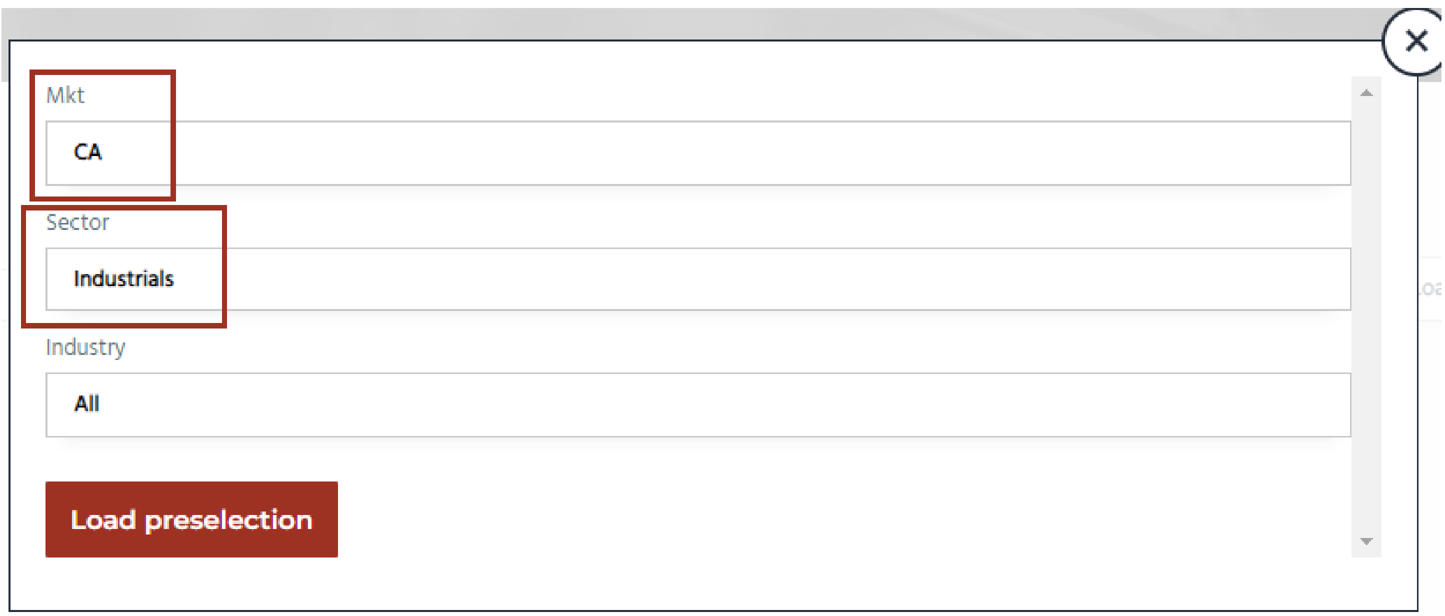
MAKE A PLAY ON AN INDUSTRY? USE THE STOCK COMPARISON TOOL!

Before we start the sector review, I'd like to highlight a feature offered to DSR PRO members:

The Stock Comparison Tool!

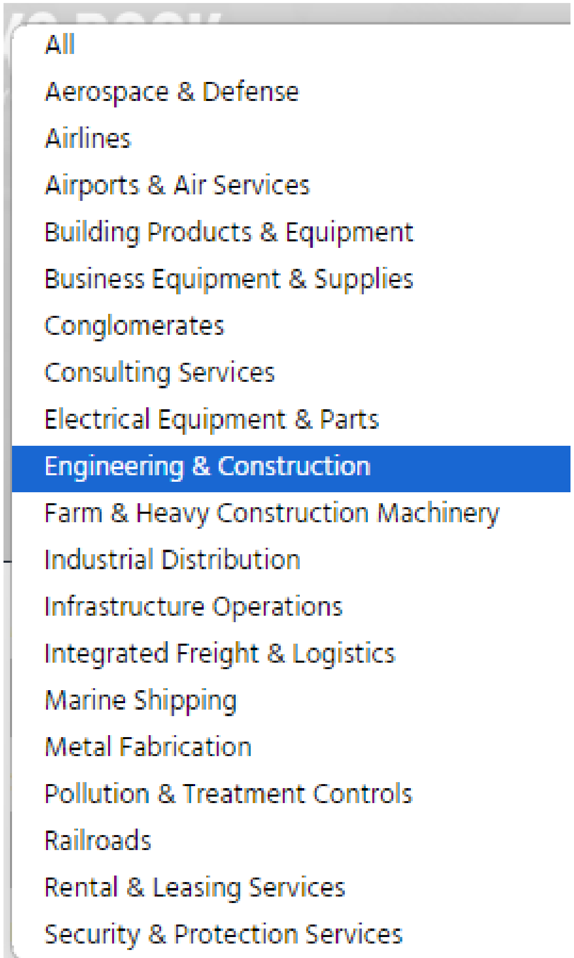
I hope you are already familiar with it, but I'd like to give you a tip on how to maximize this amazing tool. Let's say you would like to make a play on a specific industry. For example, imagine you want to capitalize on infrastructure spending in North America for the coming years. You could use the comparison tool to load all the companies operating in industries benefitting from additional infrastructure spending.

#1 Select the market and then the sector you wish explore



In this example, I want to see which Canadian companies could benefit from additional spending on infrastructure in the coming years. The first sector that comes to my mind is "industrials". At this stage, if you are not sure which sector is best for your ideas, you can look at the industries to get a better idea of which sector would fit the best for your concept.

#2 Select an industry that you are interested in



As you can see, there are several industries (sub-sectors) that could benefit from infrastructure spending. Companies offering building products & equipment, equipment & supplies, consulting services, electrical equipment & parts, engineering & Construction, etc.

You can only select one industry to load a pre-selection. You may think it's not that convenient as you could do multiple selections in this case.

Here's why you can't select more than one industry at a time:

Companies with different business models will have different challenges, growth vectors and will show different metrics.

For example, an engineering firm is likely to be capital-light (there is no need for massive investment in assets and have large amortization when your most important asset is your talented engineers). If you compare an engineering firm with a railroad operator, ratios and other financial metrics will be completely different.

Therefore, you are better off looking at engineering firms and compare them to their peers in order to select the best one. You can also select 2-3 companies from different industries, but in the same sector to improve your diversification. There is little link between a defense contractor, a railroad operator and a rental & leasing service business. While you increase your exposure to the industrial sector, you do it in a way that you improve your diversification (as opposed to selecting 4 railway companies).

If you hesitate between two picks, use the comparison tool to select the one with the best financial metrics!

A NOTE ON SECTOR NOMENCLATURE

Before we start reviewing sectors, I'd like to highlight an important point that often comes up in discussions among investors. Many will ask questions such as:

Why a stock like Dow (DOW) is listed as Materials and not Industrials?

Why Visa (V) & Mastercard (MA) are listed as financial services and not information technology?

Why CCL Industries (CCL.B.TO) is listed as Materials and not Consumer Discretionary?

Those are all valid questions as some companies could qualify for more than one sector. For example, Visa and Mastercard could be seen as being part of the financial services sector since they both process payments. However, since their strengths rely on their network and technology and they do not carry consumer debt on their balance sheet (that belongs to the bank issuing the card), it can also be a tech stock. Finally, Visa and Mastercard's revenue is dependent on how much consumers spend. During a recession, consumers will likely spend less on travel and cross-border payments which are great sources of revenue for credit card companies. Therefore, one could also argue they are also part of the consumer discretionary sector.

Since we can't attribute multiple sectors to one company, we go with a commonly accepted nomenclature provided by Refinitiv, a London Stock Exchange company whose service is like Bloomberg's. Also keep in mind there are changes in the sector attribution. For example, Disney went from consumer discretionary to communications, Amazon went from information technology to consumer discretionary. As business models and the economic environment changes, sector nomenclature evolves accordingly.

The reason why knowing your stock's sector is important is to add color to your analysis. It will help you understand in which situation a company in a specific sector will thrive or experience challenges. The sector nomenclature is a guide that will help you in your analysis, but it's not a shortcut. The most important part is to understand the company's business model thoroughly and be able to know which companies could fit in more than one sector.

This will also help in your portfolio analysis when you look at sector allocation. If you are overweight in technology stocks but show a 5% position in Visa, you might want to review your allocation considering this company as being 1/3 tech, 1/3 finance and 1/3 cyclical. The principle behind having wide sector diversification is to ensure less volatility in your portfolio. Fully understanding a company's business model will also help you understand the level of volatility you face in your portfolio.

This sector review will help you get a better understanding of how to get the best of each sector and to also be fully aware of each sector's potential downside.

Now, let's get started!

COMMUNICATION SERVICES

When you think of the communication services sector, you may automatically think of AT&T (T), Verizon (VZ), BCE (BCE.TO / BCE), or Telus (T.TO / TU). Those companies are praised by income-seeking investors as they pay high yields and have shown consistent dividend growth. While their increases are sometimes modest, these companies' dividend growth typically matches inflation and thereby protects their payout from being eroded by inflation. But there is more than just the wireless industry here. We are talking about all types of content from advertising to cable and now streaming and internet content. This is how "tech companies" like Meta (META) and Alphabet (GOOG) have pushed this sector on a more bullish trend. The good news for low-yield, high-growth investors is that Meta is now paying a dividend and they will be covered by DSR later in 2024!

Sub-Sector (Industry)

Advertising Agencies	Entertainment	Publishing
Broadcasting	Internet Content & Information	Telecom Services
Electronic Gaming & Multimedia		

Greatest strengths

For a dividend growth investor, I'd say the marvels are to be found in the wireless/telecom services industries. This sub-sector is packed with reliable dividend payers (other than AT&T!). Their secret? Everybody needs a phone, and we are all glad to pay monthly for it. With such reliable and predictable cash flow, telecoms have a great business model to serve income-seeking investors. Even if cable TV (broadcasting/entertainment) or magazines (publishing) are on a secular downtrend, it will take years for those industries to become bad businesses. This shows you the power of a subscription-based business model.

New technology entering a market is both a blessing and a curse. It all depends on which chair you occupy. Powerful network (5G) and streaming services will be tailwinds for the 2020-2030 decade. At the same time, it will be an important threat to any companies ignoring the trends. I doubt cable companies will thrive in 2030. They must shift toward streaming and other types of content delivery to survive.

Last year, I wrote in this guide that "*we may eventually see internet content companies such as Alphabet consider paying a dividend…*". Funny enough, Meta is the first one to initiate this trend in 2024! It would not be surprising if Alphabet eventually does the same thing. That would create more low-yield, high growth stocks!

Greatest weaknesses

Except for the telecom industry, this sector is not strong on dividend growth industries. Even one of my favorite picks (Disney) suspended its dividend in 2020. Disney reinstated its dividend in 2023 and already announced a dividend increase in 2024. While I still like the stock, I sold it in my portfolio as it became more of a distraction than anything else.

Advertising agencies are facing strong headwinds as they must adapt quickly to this new environment. They are also operating in a highly cyclical environment. Publishing and broadcasting won't attract new customers with their current business model. The advertising money is now being spent on the platforms of Google and Facebook. Classic agencies are facing major struggles.

We saw a bubble growing around the streaming industry in 2020-2021. Electronic games and internet content also surfed that same bubble. Since then, the market has realized it was quite a challenge for streamers to be profitable (besides Netflix, the uncontested leader in this industry). Therefore, most streaming companies have been struggling ever since. As I expect a recession in 2024, I don't expect a lot from most of them.

As new technology can kill or save a business like DIS created a whole new business with Disney +, your ability to forecast the future will be important to make the correct choices. If you don't want to bother with the future of technology, stay with the telecoms and you'll be fine.

Speaking of which, telecoms face another type of headwind. While we all want smartphones, the money required to develop strong networks is significant. This often leads to heavy debt loads for many players. This industry is capital-intensive, and you must always keep that in mind. Interest rates aren't going down significantly anytime soon. So, do not overexpose your portfolio to telcos with high debt levels.

How to get the best of it

I like having a few boring stocks in my portfolio. Since I'm 100% invested in equities all the time I usually pick a few companies with limited growth potential but solid dividends. Telecom companies fit this description well. If you are more adventurous, you can look at electronic gaming, entertainment, and internet content industries to find some growth stocks. The choice is limited when it comes to dividend growers though. Therefore, I made an exception in keeping my DIS shares.

The telecom industry is best for income investors.

The Electronic gaming, entertainment, and internet content industries are usually better for growth investors.

Target sector weight: Due to the lack of candidates, 3% to 10% seems to be reasonable for both income and growth investors.

Favorite Picks

U.S.: Disney (DIS).

Canada: Telus (T.TO / TU), BCE (BCE.TO / BCE).

CONSUMER DISCRETIONNARY (CONSUMER CYCLICAL)

This is an "all-you-fit-in" sector. At DSR, we use the term "consumer discretionary", but you can also find the term "consumer cyclical" in financial literature. The bottom line is these companies make goods that are fun to have (or consume) but are not necessary. Therefore, they follow economic cycles and consumers' sentiment. These are the expenses you incur once you have covered the basics, and you have some extra money. When the economy booms, consumer discretionary stocks follow. Keep in mind that Amazon (AMZN) isn't a tech stock anymore as it is retail, and that is part of the consumer cyclical sector.

Sub-Sector (Industry)

Apparel Manufacturing	Gambling	Recreational Vehicles
Apparel Retail	Home Improvement Retail	Residential Construction
Auto & Truck Dealerships	Internet Retail	Resorts & Casinos
Auto Manufacturers	Leisure	Restaurants
Auto-Parts	Lodging	Specialty Retail
Department Stores	Luxury Goods	Textile Manufacturing
Footwear & Accessories	Packaging & Containers	Travel Services
Furnishings, Fixtures & Appliances	Personal Services	

Greatest strengths

This is one of my favorite sectors when I want to secure growth stocks. This is also a unique sector where you can devote over 20% of your portfolio and still maintain wide diversification. The buying process for a new car isn't the same as for a burger or a t-shirt. Some companies in this sector could be surprisingly recession resistant too (thinking of McDonald's and its value meals, for example). You can select great companies from several different industries and build a solid portfolio. My own portfolio includes around 10-12% of consumer discretionary stocks. I have companies in home renovation (Home Depot), auto parts (Magna), restaurants (Starbucks), and internet retail (Amazon). Let's just not fall in love with a single sub-sector. Remember they all look good on prom night.

Some of these industries have amazing dividend growers. The key for these companies is to build a strong brand that serves them well over time. Brands like Nike, Home Depot, McDonald's, and Starbucks in the U.S. and Ski-Doo, Tim Horton's, Dollarama, and Canadian Tires in Canada are iconic brands. Those companies will do better when the economy booms, but they will also be resilient during recessions. The cyclical aspect of this sector will also propel your returns if you buy during economic downturns.

Greatest weaknesses

Unfortunately, while consumer cyclical companies can show double-digit growth during good years, the winds can change quickly. Inflation has forced central banks to increase rates in 2022 and 2023. We all hope for a "smooth landing", but chances are we will get into a recession. This will have a direct impact on consumers' budgets and, obviously, on consumer discretionary purchases. Companies' margins will get squeezed by inflation and labor shortages while consumers will work with restricted budgets. 2024 will be a tough year for this sector. This is what I like to call "looking good on Prom night". When people have jobs and are confident in their future, there is virtually no limit to growth. You'll see impressive sales growth for several years in a row giving you the impression that it will last forever. Due to the cyclical nature of this sector, however, nothing lasts forever. We had a good example with what happened to VF Corporation, a legendary brand manager that eventually failed its shareholders in early 2023 with a dividend cut after 50 years of consecutive increases. Did we say "cyclical"?

E-commerce has become a great disruptor for many industries in this sector. We have seen a wide range of retailers going bust in the past and this trend will continue. Direct-to-consumer sales (e.g., Nike selling you shoes directly through your computer or phone) has become a vital element of their business model. Those who resist will fail. Brick & mortar retail isn't dead, but it must work hand in hand with a digital sales space for overall company success.

How to get the best of it

While one must not get blinded by a strong brand, this is probably the first thing you should look for when selecting stocks in consumer cyclicals. When you have extra money, you want to reward yourself. Chances are you will feel a lot better with a pair of Nike shoes than some "Mikeymike brand" shoes at the discount outlet.

Quality matters even more when we talk about the extra dollar. This is where the margin is: perceived value brings pricing power. How do you think Starbucks can make you smile after you spent $7 on a coffee that probably cost $0.50 to make?

Following economic trends will tell you a great deal about how many industries will do. Unemployment rates, consumer sentiment indices, and job stats will help you to be on top of things.

Most industries are best fit for growth investors.

Target sector weight: For income investors, 3% to 10% should be enough (due to lack of generous yields). For growth investors, you can load up your portfolio with a 10% to 20% weighting in this sector.

Favorite Picks

U.S.: Starbucks (SBUX), McDonald's (MCD), Home Depot (HD), Genuine Parts (GPC), Nike (NKE).

Canada: Canadian Tire (CTC.A.TO), Dollarama (DOL.TO), Magna Intl (MG.TO/MGA), BRP (DOO.TO/DOOO).

CONSUMER STAPLES (CONSUMER DEFENSIVE)

Like consumer discretionary, consumer staples stocks also have an alternate name: consumer defensive. When we discuss consumer staples, we often describe it as all the products you can find in your house. Those are products you must buy no matter what happens in your life. These companies have built stellar brand portfolios supporting repeat purchases. Repeat purchases lead to constant and predictable cash flows. Therefore, food, beverage and household products could be a great foundation for building a dividend growth portfolio. If you are concerned about the current state of the economy, add some consumer defensive stocks to your portfolio.

Sub-Sector (Industry)

Beverages - Brewers	Discount Stores	Grocery Stores
Beverages - Non-Alcoholic	Education & Training Services	Household & Personal Products
Beverages - Wineries & Distilleries	Farm Products	Packaged Foods
Confectioners	Food Distribution	Tobacco

Greatest strengths

If you are looking for a place to stash your cash during tough times, forget about your mattress. Consumer staples stocks are defensive. When the market goes into panic mode, this part of the equity markets isn't normally a source of worry. We clearly have seen how grocery and discount stores have done during the pandemic in 2020. Besides healthcare services, they were the first to be named as “essential businesses”.

On top of selling “essential goods” (we could discuss how alcoholic and tobacco products are considered as essential another time), this sector also shows another great characteristic. Most of its industries have built their business model around repetitive sales. What's better for a dividend investor than to find a business that keeps selling the same products to the same consumers every week? This is what we call a cash cow.

Since we rely on many of these products, consumers will likely cut their expenses toward the consumer discretionary sector's products and prioritize consumer staples companies' products. Keep in mind that while this sector offers great protection when the market goes sideways, one must hold them ***before*** market sentiment shifts to benefit from the protection. When the market panics, consumer staples are usually trading at higher valuations (read higher PE ratios).

Throughout the years, many of these businesses have built iconic brands. You will even find companies managing portfolios of multibillion-dollar brands. Such large brands come with economies of scale and a wide distribution network. This increases the barriers to entry for potential competitors. This also provides many investors a sentiment of calm as they can count on their dividend no matter what happens. Even better, when people lose their job, they will normally keep buying many of these brands!

Greatest weaknesses

Growth is often a matter of concern for this sector. When emerging markets came into play, they all rode the wave and discovered new playgrounds. As those markets grew many local competitors came on the scene. Smaller players normally can't compete on price and scale. However, they are more flexible and know their customers better than those "gringos" coming from North America. Buy America or buy local is not just a slogan that we have here in our countries. It's a movement trending around the world.

Speaking of competition, it now comes from everywhere. Beverage companies go after snacks and packaged foods industries while some discount stores first introduced packaged foods before transforming into full grocery stores. Such competition first created a shelf war where products had to compete against each other for top space in stores. This has now moved to the online world where shopping online has reached all industries. Margins are getting squeezed and inflation has done nothing to help those industries.

Those "old" companies must adapt to e-commerce as well. Many of those companies face similar challenges that consumer cyclicals face when it comes down to dealing with digital sales. Even groceries must invest massively in their online platform to enable consumers to order their food and pick it up at the store.

How to get the best of it

It's hard to determine a good time to buy consumer defensive stocks as they are rarely "on sale". When everybody is making money in the market and growth stocks get most of the love, you have a shot at buying unloved consumer staples. This is the type of investment that will make you almost regret having made the investment during a bullish year. They will often lag and show minimal growth during boom times. On the other hand, when panic spreads, these companies will hold the fort and make sure your portfolio doesn't go bust.

Most industries are best fit for income investors. Not for their average yield, but rather for the stability they bring to one's portfolio.

Target sector weight: For income investors, you can get some "safe stocks" for 10% to 20% of your portfolio. You are not going to generate a maximum of dividend payments from this sector, but you will reduce value volatility. For growth investors, anything between 3% to 10% would work well. Too much money invested in this sector would impact your total return potential during a bull market.

Favorite Picks

U.S.: Costco (COST), Procter & Gamble (PG), Coca-Cola (KO), PepsiCo (PEP), McCormick & Company (MKC), Hershey (HSY).

Canada: Alimentation Couche-Tard (ATD.TO), Jamieson Wellness (JWEL.TO), Premium Brands Holdings (PBH.TO), Metro (MRU.TO).

ENERGY

The world needs energy to function. The oil & gas industry has been fascinating investors for several decades. I guess this is due to the thrill coming from the next exploration results or an oil boom pushing oil and gas stocks to record levels. The oil & gas industry is usually divided into three activities:

Upstream: this term represents all activities related to exploration and production. This is usually the phase where the commodity price is the most important. Companies will establish their financial projections based on a specific price (or cost) per barrel. Then, they will decide to explore (drill wells) or not depending on the likelihood of profitable operations.

Midstream: Midstream activities include the processing, storing, and transporting of oil & gas and their by-products. This is where you will find pipeline related businesses. The transportation and storage activities are usually more stable as they usually operate on long-term contracts with producers.

Downstream: this is the final step of the process including refining (to produce gasoline for example) and marketing the product (selling it to the end-customer). Don't just think about gasoline, but all the other modified products such as liquefied natural gas, heating oil, synthetic rubber, plastics, lubricants, antifreeze, fertilizers, asphalt, and pesticides.

Please note that all "renewable energy" companies are part of the utility sector, not the energy sector.

Sub-Sector (Industry)

Oil & Gas Drilling	Oil & Gas Integrated	Thermal Coal
Oil & Gas E&P	Oil & Gas Midstream	Uranium
Oil & Gas Equipment & Services	Oil & Gas Refining & Marketing	

Greatest strengths

Oil & gas stocks will raise passions and attract many investors during bull markets (especially after the boom in 2021). As the economy grows, demand for such products increases accordingly. Commodity prices go up, profits skyrocket, and dividends are generous. The problem is that it rarely stays that way. We have already seen a slowdown since the summer of 2022. During 2023, experts told investors to "wait for summer vacation" and then "wait for winter and heating demands". They claim that another energy bull market is around the corner. The problem is that they say this every year for as long as I've invested (since 2003).

The energy sector can generate great returns in your portfolio, but you will be required to follow this sector closely (and hopefully know what you are doing). If you can pick stocks during oil busts (as was the case back in March-April 2020), you will show double-digit (sometimes triple-digit) returns. Since we do not employ a "buy and sell quickly" strategy, we rarely like energy stocks at DSR. They generally make unreliable dividend growers.

Finally, the energy sector is a great hedge against inflation. Along with other commodities, energy companies can easily pass price increases to their customers as it's linked to supply vs. demand. There is usually a portion of the inflation that is directly driven by rising commodity prices. If you hold commodity-linked businesses, you will be sheltered from most inflation.

Greatest weaknesses

The energy sector is quite volatile and cyclical. This is not the best place to pick dividend growers. Many companies will attract investors with their high yield and generous promises, but they will eventually fail their shareholders. I've heard the best and the worst stories coming out of this sector. Therefore, it is crucial to do your homework prior to investing in the Energy sector.

The main problem with this sector is it is capital-intensive, and profits often depend on commodity prices. Companies have little to no control over the prices they receive for their oil or natural gas. Therefore, they spend billions on projects and hope the end price will remain profitable for several years. We are seeing pipeline companies having difficulties with their budgets as inflation, labor shortages, delays, and regulators are increasing costs of construction and maintenance. While the sector enjoys stronger commodity prices, it also faces higher interest rates.

Vertically integrated companies (upstream, midstream, and downstream) tend to maintain their dividend payments no matter what, but it is still a risky business. For example, BP (BP) had to cut its dividend after a major oil spill. Royal Dutch Shell (RDS.A or RDS.B) and Suncor (SU.TO / SU) also cut their distributions following the oil debacle in 2020. Fortunately, they are usually quick to get the dividend back on track whenever commodity prices surge. If you are comfortable with volatility and don't mind getting your dividend cut once in a while, you can enjoy strong capital gains and impressive dividend increases (following cuts). Do not be blindsided by impressive headlines such as **"Suncor doubles its dividend"**. SU's dividend went from $0.465/share before the pandemic to $0.21, to $0.42 (when it doubled), and now starting 2024 at $0.545. So, it's **a 17.2% increase (or a 4.05% annualized growth rate) between February 2020 and February 2024.**

How to get the best of it

The energy sector is the most cyclical of all the sectors. If you are courageous enough to ride the roller coaster, you can grab shares at highly depreciated prices every few years. If you would rather stay focused on a dividend growth investing strategy as we do here at DSR, you must be incredibly picky before investing a penny in this sector.

However, there are a few exceptions including pipelines like Enbridge, TC Energy, and vertically integrated companies such as Imperial Oil, Chevron, Exxon Mobil, and Canadian Natural Resources that didn't cut their dividend during 2020. Most of them (besides Exxon) even increased their dividend each year for several years in a row.

I think pipelines (the midstream industry) are part of the most interesting opportunities in the energy sector. Pipelines are capital-intensive and exposed to regulators and potential oil spills, but they also act as toll roads. The world needs energy and pipelines are the ones providing it. However, considering inflation and higher interest rates, companies like Enbridge and TC Energy are likely going to be deluxe bonds (companies with little capital appreciation potential, but with a generous yield) over the coming years. Watching over their quarterly earnings to ensure the payout ratio remains in order is now crucial as their funds from operations could be hurt by delays, inflation, and higher debt burdens.

This sector is more suitable for a growth investor. If you are retired and looking to enjoy a peaceful retirement, you may want to ignore this sector completely. One or two pipelines could help boosting your dividend income, but please make sure you don't get "Kindered".

Target sector weight: Since this sector doesn't offer the best dividend growers in town, I'd say that a 5% exposure should be enough (unless you really like roller coasters!).

Favorite Picks

U.S.: Chevron (CVX), Exxon Mobil (XOM) and Enterprise Products Partners (EPD) have not failed their shareholders, but I'm not a huge fan.

Canada: Canadian Natural Resources (CNQ.TO/CNQ), Imperial Oil (IMO.TO/IMO), Topaz Energy (TPZ.TO) and TC Energy (TRP.TO/TRP), Enbridge (ENB.TO/ENB) for income-seeking investors (please keep in mind those pipelines must be followed closely).

FINANCIAL SERVICES

The Financial Services sector is both exciting and scary for dividend investors. On the one hand, you have solid banks which are the heart of our capitalist system. They are a sign of trust, stability, and growth. On the other hand, you think about all the exotic financial strategies like mortgage-backed securities, options, and swaps. You realize that even those who manufactured those products don't always understand the complexity of the monster they created. To simply things a little, you can divide financials into three distinct sub-sectors:

Asset managers: companies that are managing/investing money for others. Mutual funds, hedge funds, real asset managers, and ETF managers are part of this group. Asset managers usually perform consistently with the overall market. It is very rare to see an asset manager's stock price increase during a bear market.

Banks: you can sub-divide this group into global and regional banks. You can also look at investment banking, commercial banking, or the credit side as individual industries. In the end, it all comes down to deposits and loans. This group benefits from higher interest rates as the spread between loan rates and deposit rates will often play to their advantage.

Insurance: this last financial segment includes life, property & casualty, reinsurance, speciality, and brokers. Insurance companies require strong asset management skills to align their revenues with potential claims costs. It is also easier for them to manage their assets during higher interest rate periods.

Sub-Sector (Industry)

Asset Management	Financial Conglomerates	Insurance - Reinsurance
Banks - Diversified	Financial Data & Stock Exchanges	Insurance - Specialty
Banks - Regional	Insurance - Diversified	Insurance Brokers
Capital Markets	Insurance - Life	Mortgage Finance
Credit Services	Insurance - Property & Casualty	Shell Companies

Greatest strengths

Financials represent a true investing opportunity for dividend investors. There are many strong Canadian banks, financial firms and insurance companies sharing the wealth with their shareholders. Just remember not to fall for a strategy you don't fully understand. For example, let's look at the two types of asset managers.

Asset-light (such as Brookfield Asset Management, BAM/BAM.TO): an alternative manager that doesn't have many assets, but rather manages funds coming from pension plans and other investors. BAM is responsible for managing those funds, establishing strategies and will charge a fee based on total assets under management (AUM). It's a sticky business model generating a constant flow of income.

Asset-heavy (such as Brookfield Corporation, BN/BN.TO): Brookfield Corporation will not only do the asset-light manager's job (strategy + earning fees on AUM), but it will also contribute with its own assets. Therefore, it can benefit from its strategies by selling those assets for a profit in the future. Asset recycling happens when a company sells assets that it deems to be at a very good value to reallocate the proceeds into new projects or undervalued assets. This is the classic "buy low, sell high" concept.

Asset managers will typically do very well during bull markets. They enjoy a very sticky business with recurrent cash flow (fees paid by institutional investors). There has also been an interesting shift from mutual funds toward ETF products. Leaders in ETFs or financial advisory services will lead this industry going forward. In general, there is a lot of money to be made in wealth management.

Second, I must admit Canadian banks are unique. The Big Six operate an oligopoly that is not only highly regulated, but also protected by the Canadian Government. In other words, they can use their core business in Canada to generate significant cash flow and use this money to grow outside those boundaries. This is how they can pay a yield of around 4% and still show a mid single digit annualized dividend growth rate over decades. Dividends were paused in 2020-2021 due to the pandemic but resumed at the end of 2021. Major banks show low payout ratios (40-60% range) and even if they had to increase their provision for credit losses (PCLs), we expect dividend increases to come in 2024.

Banks in general (US and Canadian) will give you a great hint about where the economy is going. When they increase PCLs, it decreases their earnings, and they tell you they expect more consumers to default on their loans. When they are right, they don't cause surprises down the road since you have been warned. When they are wrong (e.g., consumers pay their debts), they recover the PCLs, and it pushes their earnings up. Canadian banks are known to be conservative and "play" on the PCLs to present better earnings the following years.

Finally, I'm not a big fan of the insurance industry. I find them too dependent on external factors (catastrophes, interest rates, etc.). This is an industry I would rather ignore in my portfolio and focus on my strength which is a strong knowledge of the banking industry having been a private banker in my past.

On the positive side, however, higher interest rates in 2024 will be positive for both banks and insurance companies (even more for life insurance companies). Banks typically generate 50%+ of their income through interest income. If done gradually, rate increases could drive many consumers and businesses toward bankruptcy, but it will improve banks' interest rate spreads (which is their margin). Insurance companies must maintain a significant portion of their premium portfolios invested in bonds. With higher interest rates, they will generate better results from this portion of their asset allocation.

Greatest weaknesses

I think 2008 showed us how financial services could go from “too big to fail” to “the largest bankruptcy in history”. Most companies in this sector will seek to inspire trust. Unfortunately, trust sometimes turns into blind faith. Be a better investor and research each company thoroughly.

In early 2023, we had another bad example with SVB Financial Group (SIVB) and First Republic Bank (FRC) both failing. Banks must keep a large amount of capital on their balance sheet. In general, they don’t hold cash as it doesn’t generate enough returns. They invest in various fixed-income products (including bonds for example). What happens with most of them when interest rates rise rapidly? Fixed-income products such as bonds and preferred shares drop in value. If a bank’s collateral starts losing value, it’s a problem if the bank is not capitalized properly. If it urgently needs additional capital, it could sell assets or issue shares, which generally causes a panic on the market (such as what happened with SIVB and FRC and their stock price literally crashed). **A bank’s largest asset is the trust the market has in them**. If they lose that, all hell breaks loose. Canadian banks lost around 40-50% of their value in 2008 and they were barely affected by commercial papers and sub-prime mortgages. The problem was the trust lost during the crisis due to a big panic.

In general, interest rates and the equity markets will dictate if this sector does well or not. When interest rates are low, regional banks will see their interest rates spread, which is the difference between what they pay in interest for deposits and how much they make on loan shrink. In other words, their margin gets thinner. Insurance companies also have a similar problem. Since they must invest premium payments in a way to make more money to cover future claims and generate a profit, having an entire asset class (bonds) offering mediocre returns does not help.

When the market goes sideways, we’ll see many asset managers having a hard time. If you wonder why the market has been so volatile over the past 15 years, this is partially because of hedge funds and options and other “wild” trading strategies. As institutional investors can short positions or enter massive positions through options, they can also get into big problems. Margin calls happen when the market drops suddenly, and fund managers don’t have enough liquidity to cover the minimum value. They are then forced to sell assets pushing the market toward new bottoms.

How to get the best of it

First, understand your investment. Financial businesses often generate revenues from complex strategies. If you don't understand how a life insurance company makes money (and how it must protect its premiums), then move along and look for another sector or industry where you understand the business. For insurance companies, focus on their underwriting process. I often highlight Brookfield as an amazing company, but I also put a major emphasis on its complex structure which represents its most important downside. Size is often a key component as the larger an insurance company is, the more data it gets from its contracts. Therefore, it's easier for them to manage risk for future contracts and they can price that risk accordingly.

When there is a market panic, Canadian banks are likely going to get hit and will offer you the most reliable dividends in this industry. They have proven their resiliency during the 2008 financial crisis, and once again throughout the pandemic. Canadian Banks reported increased provisions for credit losses during that period but remained well capitalized. Entering 2024, PCLs are on the rise for a while now, but banks remain well capitalized, and all payout ratios are below 50% (besides BNS).

Going after leaders that have a diversified business model is better than a one trick pony. Most leaders will enjoy unrivaled economies of scale that are almost impossible to compete against. BlackRock (ETFs), JPMorgan (banking from A to Z) and T Rowe Price (retirement funds) show such competitive advantages.

Financial services can be a great fit for both income investors and growth investors. You can find a great variety of solid dividend growers with decent yields in this sector.

Target sector weight: For both investor types, you can aim at 10% to 20% in this sector. Please restrain yourself from falling in love with Canadian banks and buying them all. They are not Pokémons.

Favorite Picks

U.S.: BlackRock (BLK), Morgan Stanley (MS), JPMorgan (JPM), T Rowe Price (TROW).

Canada: Royal Bank (RY.TO/RY), National Bank (NA.TO/NA), Intact Financial (IFC.TO), Brookfield Corporation (BN.TO/BN), Brookfield Asset Management (BAM.TO/BAM).

HEALTH CARE

For all drug manufacturers (major, generic or specialty), biotech, diagnostics, and research companies, most of their budgets go towards Research & Development. They must manage their pipeline of new products and their patents. A company may be able to surf on its previous successes for a decade due to their patents' protection of their research. However, they must constantly renew their portfolios. This frequently impacts their ability to increase their dividends in a predictable manner. Price volatility both up and down are also frequent characteristics of companies in this industry.

As for Healthcare plans, long-term care facilities, medical care and distribution companies are more likely to be affected by governmental regulations. The cost of healthcare is a major topic for governments across the world. Should it be free, sponsored or insured? This question leads to much debate and uncertainty for the future. No matter what happens, the industry will find a way to adjust their business models, but volatility will be the continuing and on-going characteristic of this sector.

Sub-Sector (Industry)

Biotechnology	Health Information Services	Medical Distribution
Diagnostics & Research	Healthcare Plans	Medical Instruments & Supplies
Drug Manufacturers - General	Medical Care Facilities	Pharmaceutical Retailers
Drug Manufacturers - Specialty & Generic	Medical Devices	

Greatest strengths

The advantage for dividend investors in this sector is the wide choice of large and well-established companies. The best-performing companies in this sector are often the long-term established companies that have a strong distribution network or a large drug portfolio and pipelines full of new products. Big pharmaceuticals usually offer a haven for your money over the long run. They know how to manage their R&D budgets and drug pipelines. The healthcare sector often sees stock surges both upward and downward based upon the results of their discoveries. Patents and regulations are part of their daily routine.

Medical devices, instruments or supply companies will provide products with repetitive purchases. They enjoy wide distribution networks, loyal customers, and constant repeat orders. They can make great dividend growers as well.

Healthcare plans are massive companies generating sticky cash flow. The problem is usually their tiny margins and potential shifts in healthcare regulations.

Pharmaceutical retailers are relatively stable and could be seen as consumer staples stocks as they are usually recession resistant.

Greatest weaknesses

Unfortunately, as R&D budgets are often a huge part of a healthcare company's expenses, there are many companies showing an erratic dividend growth track record. It is not that they will cut their dividend, but you may be waiting for a few years before seeing a dividend increase. Do not forget that many drugs never reach the market, but companies spend millions (sometimes billions) developing them. Lawsuits and product recalls are also a hanging threat. Therefore, it's not ideal to have a big exposure to a single stock in this sector.

When you consider healthcare plans and the medical distribution industries, they face harsh competition and must operate in a razor-thin margin environment. If they make one bad acquisition or hit a speed bump, those companies may see cash flow evaporate quickly. There are currently many changes and pending changes in the air around healthcare regulations. There is a political will to make healthcare more affordable. This could have an impact on those industries.

Finally, Medical care facilities have had their fair share of problems in the past. After the pandemic, it has become quite a challenge to manage the increasing expenses to make sure both employees and seniors are safe, and they have weaker occupancy rates than has been true historically. Proceed with caution.

How to get the best of it

Big pharmaceuticals will often come with massive stock price fluctuations. A patent expiring, news about a new drug or a major acquisition could contribute to Mr. Market's mood swing. These situations give you your chance to pick a solid dividend grower at a reduced price. I picked up shares of Johnson & Johnson (JNJ) during their quality control issues back in 2012-2013 and benefited greatly from that move.

In general, the healthcare industry is capital-intensive or requires a significant size to perform efficiently. Make sure the debt burden on your chosen company is not too large to manage efficiently. For distribution and healthcare plans, take a close look at their margins over time. Those companies operate with razor thin margins.

The healthcare sector is usually ignored during bull markets. There are more exciting companies to buy, and this could translate into a good buying opportunity. Most importantly, you must be patient with healthcare businesses. It may take time before the market realizes the value inherent in a particular company's stock.

The healthcare sector is best for income investors.

Target sector weight: Due to the lack of candidates with a decent yield, 3% to 10% seems to be reasonable for both income and growth investors.

Favorite Picks

U.S.: Johnson & Johnson (JNJ), AbbVie (ABBV), Lemaitre Vascular (LMAT), Abbott Laboratories (ABT).

Canada: well, hum… none! There are only a few senior REITs in this category.

WHAT'S COMING NEXT WEEK

In addition to the last five sectors, I will also discuss various topics about sectors. We will cover sector allocation; sector rotation and I'll offer more insight into how to target tech stocks for your portfolio. Many members have asked me how to "trust" and assess the value of tech stocks while not picking the next BlackBerry or Nortel. I'll go into greater depth for this sector.

As you can well imagine, this two-part newsletter is part of our DSR fundamentals section. This section allows you to easily retrieve our "must reads" newsletter editions. You will find here the fundamentals of the DSR investing strategy as well as the newsletter issues members liked the most.

If you feel there is anything missing in our sector newsletters or if you want to know more, please let me know. The DSR fundamentals will be reviewed each year and I intend to update and improve those newsletters every year.

I continue to count on your feedback to make DSR the best dividend growth investing platform in North America!

Take care,

Mike.

RATING CHANGES

This section communicates rating changes on the most popular stocks held at DSR. The changes mentioned below happened during this week upon our latest review.

No changes this week.

COMPANY	SYMBOL	PREVIOUS RATINGS (PRO/DIV)	NEW RATINGS (PRO/DIV)	COMMENT

OVERALL PORTFOLIO PERFORMANCE

Listed Returns are as of February 15th, 2024:

Portfolios	Inception Date	Return	Benchmark	Added Value	Annualized Return	1 Y	YTD
CAD 25K	10/31/13	207.33%	135.33%	72.01%	11.42%	11.20%	-0.46%
USD 25K	10/31/13	173.14%	196.84%	-23.70%	10.16%	5.71%	-0.46%
CAD 100K	10/31/13	135.98%	135.33%	0.65%	8.62%	7.95%	-0.84%
USD 100K	10/31/13	226.85%	196.84%	30.01%	12.08%	15.29%	0.74%
USD 500K	05/31/14	117.75%	163.42%	-45.68%	8.34%	8.60%	0.39%
CAD 500K	05/31/14	129.05%	107.06%	21.99%	8.90%	7.97%	0.71%
100% CAD	07/31/17	81.98%	48.32%	33.65%	9.71%	7.62%	0.52%
Retirement CAD	07/31/18	27.07%	37.04%	-9.97%	4.41%	-4.39%	-1.89%
Retirement USD	07/31/18	61.75%	79.08%	-17.33%	9.05%	3.16%	-2.58%

*Canadian portfolios added value is calculated based on 50% of VIG and 50% of XDV as half of portfolios are US stocks. Currency hasn't been taken into consideration.

Benchmarks are VIG and XDV.TO for all portfolios.