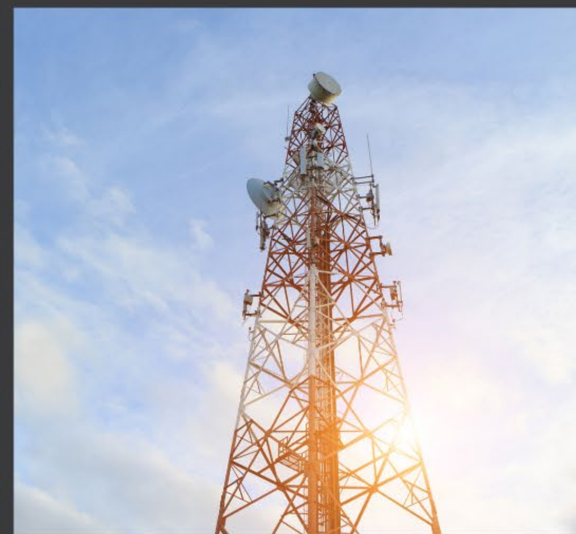
DSR BOOKLET

GET THE BEST OF 6 SECTORS



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A LITTLE ABOUT ME

My name is Mike Heroux and I'm the author of The Dividend Guy Blog, The Dividend Monk, and Moose Markets (yes, I thrive on staying busy!) along with being the co-owner and portfolio manager at Dividend Stocks Rock (DSR). I have an unusual sense of humor for a "nerdy finance guy". Before you decide if you trust me or not, let's get to the "boring & serious" stuff first.

I earned my bachelor's degree with a double major in finance and marketing, I completed a CFP (Certified Financial Planner) certification along with an MBA in financial services. I worked in the financial industry for over a decade including 5 years as a financial planner and another 5 as a private banker managing accounts for high net worth (read $1M+) clients.

Besides being a passionate investor, I'm also happily married with three amazing children, and I live in the beautiful province of Quebec, Canada. I started my online venture to capitalize on my education and professional background by educating people about investing. A most fortunate by product of this professional endeavor is that I can work from home which allows me to be able to spend more time with my family.

In 2016, I decided to leave everything behind and go for a 1-year RV trip across North America and Central America (we made it all the way down to Costa Rica). Upon my return in 2017, I quit my job as a private banker and invested all my energy in my online business. I would rather pursue my dream of helping people invest through my sites. Since then, I have been a full-time online entrepreneur.

You can read more about my investing journey here.

IN THIS BOOKLET…

We cover six of the eleven sectors on the stock markets. Complete review is exclusive to DSR members. More specifically, we'll analyze each by its subsectors, strengths & weaknesses, how to get the best of it, and favorite picks. Sectors included:

- Communication Services
- Consumer discretionary
- Consumer staples
- Financial Services
- Industrials
- Information Technology

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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.

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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 mximize 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 to explore

Mkt

CA

Sector

Industrials

Industry

All

Load preselection

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.

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#2 Select an industry that you are interested in

- All
- Aerospace & Defense
- Airlines
- Airports & Air Services
- Building Products & Equipment
- Business Equipment & Supplies
- Conglomerates
- Consulting Services
- Electrical Equipment & Parts
- Engineering & Construction
- Farm & Heavy Construction Machinery
- Industrial Distribution
- Infrastructure Operations
- Integrated Freight & Logistics
- Marine Shipping
- Metal Fabrication
- Pollution & Treatment Controls
- Railroads
- Rental & Leasing Services
- Security & Protection Services

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!

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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!

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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.

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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).

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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.

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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).

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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!

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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).

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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.

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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.

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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.

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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).

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INDUSTRIALS

I often have the feeling we may overlook the industrials. There is nothing sexy about them. There are often minimal stimuli to create hype on the stock market. Even worse, this sector is not seen as a source for high dividend yields. As many industries operate through unique economic cycles, there are always a few industrials for sale.

Many industrial companies are 50+ years old. This is probably one of the few sectors where you can list many companies that have survived through a whole century. Due to their long-standing existence, they have built solid core businesses and commensurate impressive brand recognition. Those who have survived the passage of time and found ways to evolve often make solid dividend payers.

Sub-Sector (Industry)

Aerospace & Defense	Farm & Heavy Construction Machinery	Rental & Leasing Services
Airlines	Industrial Distribution	Security & Protection Services
Airports & Air Services	Infrastructure Operations	Specialty Business Services
Building Products & Equipment	Integrated Freight & Logistics	Specialty Industrial Machinery
Business Equipment & Supplies	Marine Shipping	Staffing & Employment Services
Conglomerates	Metal Fabrication	Tools & Accessories
Consulting Services	Pollution & Treatment Controls	Trucking
Electrical Equipment & Parts	Railroads	Waste Management
Engineering & Construction		

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Greatest strengths

Barriers to entry are legion in most of the industries in this sector. It's quite difficult to secure military contracts or to build railways for a new, inexperienced company. Most industrials are large companies involved in massive spending in R&D and operate enormous facilities around the world. Since many industrials are old companies, you can often pick a business that has survived the last three recessions and kept its dividend alive as well. This is proof of time and sustainability when you can survive and thrive over repetitive challenging periods in the market.

Many industries will also enjoy repetitive contracts or sales. While the overall demand will fluctuate to follow the economy, those enterprises can often count on a solid core of demand coming from their customers. In many cases they operate sticky business models. Industrials will develop extensive expertise in niche domains and will offer customized solutions to their customers. It makes the switching costs significant when your entire business is tied to services or products that have been co-developed with your suppliers.

Finally, there is always a thriving industry among the industrials. This means you can surf several tailwinds if you follow macro economic data carefully.

Greatest weaknesses

The most significant problem with industrials is probably the fact that they often become too large to be managed effectively. We are all aware of the multiple problems at General Electric (GE) which has had to cut its dividend twice between 2008 and 2018. 3M is facing multiple legal issues and decided to spin-off a portion of its activities to "simplify" (and hopefully mitigate legal impacts) its business. In other words, the longevity of a company is not necessarily an accurate predictor of its likelihood of paying or increasing its dividend.

The other characteristic to track for industrials is their size as a business and their debt levels. Companies that have existed for long periods of time tend to grow through different segments and divisions. At one point, you look at the company and it becomes very difficult to fully understand where their true expertise resides. This is what happened with GE. With higher interest rates, we see companies running into troubles.

Industrials are often required to invest massively in R&D and the construction of their facilities. When demand slows down, the company is often left with unused machinery and resources. Those are costly moments.

Finally, Industrials will likely be a victim of inflation. Many will suffer from the higher costs of raw materials and there is a limit to how much of their cost increases they can pass on to their customers.

How to get the best of it

Industrials are likely to follow cycles. Railroads, construction equipment companies, truck manufacturing, and trucking transportation will be busy during economic booms but will suffer during recessions. If you follow a specific industry closely, you will be able to catch great businesses when their stock price is devalued by the market.

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There are several fragmented markets where a leader will make acquisitions to increase its market share. You can either target smaller players with low debt or go for the major player who wants to consolidate its position.

The industrial sector is best for growth investors, but you can often find some solid candidates for income investors.

Target sector weight: Depending on the number of industries you select; you could definitely have between 5% and 25% in this sector. This is a flexible sector for all types of investors.

Favorite Picks

U.S.: Automatic Data Processing (ADP), Lockheed Martin (LMT), A.O. Smith (AOS), Union Pacific (UNP), Honeywell (HON).

Canada: TFI International (TFII.TO / TFII), Canadian National Railway (CNR.TO / CNI), Toromont Industries (TIH.TO), Richelieu Hardware (RCH.TO). And a mention to CAE (CAE.TO / CAE) even if the company stopped paying a dividend.

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INFORMATION TECHNOLOGY

We will separate information technology stocks into two different categories:

#1 Companies with disruptive technology entering various fields such as retail (Amazon, Shopify), Television (Netflix), Financials (Robinhood) or accommodation (Airbnb). Those companies are fighting for market share, and they are growing rapidly. They are not typically interested in paying dividends. Many are burning cash and could be quite volatile.

#2 Companies that were once growing rapidly through technology breakthroughs but have now grown-up. These are the "adult" tech stocks that are well established in their respective markets. Since it's in their DNA to develop new technology, they are still manifesting several growth vectors.

At Dividend Stocks Rock, we are interested in the latter. Older tech stocks have developed markets that are relatively mature now. We can visualize Microsoft at the very beginning of the PC era. Now that consumers are shifting toward smartphones and tablets, PC sales are slowing down. However, MSFT still enjoys strong cash flow generation from their original business activities. At the same time, they have also developed other technologies (cloud, big data, data center, and recently artificial intelligence, etc.) that enables them to post high-single digit to double-digit revenue growth each year.

Sub-Sector (Industry)

Communication Equipment	Electronics & Computer Distribution	Semiconductor
Computer Hardware	Information Technology Services	Software - Application
Consumer Electronics	Scientific & Technical Instruments	Software - Infrastructure
Electronic Components	Semiconductor Equipment & Materials	Solar

Greatest strengths

If you want to find dividend payers among tech stocks, your best bet is in the semiconductor industry. This is where you will find companies like Broadcom (AVGO), Texas Instruments (TXN), Qualcomm (QCOM), Analog Devices (ADI), NVIDIA (NVDA) and Taiwan Semiconductor (TSM). They are all "old" techs that have gone through several technology cycles and found ways to become larger and financially stable. Today, many are showing great promise for future growth. Their expertise, size and reputation are their best assets. With the shortage of chips, many semiconductors had weaker results in 2022 and saw their stock price drop. Last year, we mentioned it was a great time to fill up your portfolio with tech stocks. 2023 was a great year for tech, indeed!

You can treat the semiconductor segments like industrials. They are capital-intensive, they enjoy strong barriers to entry, they sell essential products, and they are highly cyclical. With the rise of AI, you will find several semiconductors and also companies providing equipment & materials (ASML, LRCX and KLAC) on the rise. The need for chips and powerful computers to support AI has opened another growth vector for this industry.

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Another industry that is on the rise in Canada is software or often called SaaS (software as a service). SaaS businesses are built around my favorite concept: **recurring revenues.** You will find companies like Absolute Software (ABST.TO), Enghouse (ENGH.TO), Open Text (OTEX.TO/OTEX), Constellation Software (CSU.TO) and Tecsys (TCS.TO). Those companies will usually use their cash flow generation capabilities to acquire smaller firms to increase their market share and grow their revenues. Their yield may be minimal, but their dividend growth and capital growth prospects are interesting. One must be careful when investing in these companies. We saw how Sylogist's (SYZ.TO) great dividend growth story ended with 9 consecutive years of dividend increases and then a massive axe swing in its distribution.

As technology is used everywhere, tech stocks are not just small-hyped companies that surge and then die. Many companies are now solid dividend growers and show great growth perspectives. I'll cover how to buy them at the end of this newsletter.

Greatest weaknesses

It is unusual to find tech stocks with a high dividend yield. If you are looking for a tech stock with a 6% yield, you will not find them on our list. We use this sector to boost our portfolio's value appreciation while supporting a minimum level of income.

The risk with tech stocks is to fall for the proverbial "false hope". "Hope" that a new technology breakthrough will happen and save the business. "Hope" that the stock price will skyrocket during the next quarter. "Hope" that you will find the next Microsoft or Apple (AAPL). You are better off keeping the ones who have proven themselves instead of looking for the next homerun. If you continue with a "hope strategy", you will create your own tech bubble and no doubt get burnt.

That "hope strategy" was also at the center of Sylogist's mess. The company offered a compelling investment thesis (fragmented market, low debt, a new CEO with a growth by acquisition strategy). While the company could afford to pay the dividend and we "hoped" it would stick to the original plan, Sylogist was known as a long-time dividend grower for many years, but the new CEO saw things differently. The investment thesis is still interesting, but SYZ is not a dividend grower anymore and was sold right after the dividend cut for that reason.

The lack of innovation could also be costly for tech stocks. Intel had a great opportunity to become a growth stock with data centers and it worked for a few years. Unfortunately, the company ran into multiple innovation problems, and is now lagging its peers in new-tech chips construction (AMD, TSM and NVDA are growing their market share). This sad story ended with a dividend cut in early 2023 after another disappointing quarter.

The second risk with tech stocks is obviously the speed at which technology evolves over time. You never know if you are holding the next BlackBerry (BB) or the next Apple in your portfolio. Therefore, it is important to select companies that have a well-established growing business model, and they multiply that growth through other avenues at the same time.

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Considering how fast tech stocks rose in 2023, there is a third risk that is worth mentioning: paying too much! We are seeing several cases of PE expansion. This phenomenon happens when a stock price rises faster that its earnings per share (EPS). In other words, investors are ready to pay a higher multiple of earnings for the same company based on greater assumptions. When the company meets expectations, everybody is happy. However, when the company reports good, but not good enough results, the stock price could fall sharply. For example, I wouldn't be surprised to see MSFT shares drop by 10% if it reports single-digit growth for a few quarters in a row. The market expects more and has priced the stock accordingly.

How to get the best of it

It seems counter-intuitive to use dividend metrics to select companies that are anything but high yielders. However, if you use the dividend triangle to determine which tech stock to buy, you are likely to acquire a company thriving in its environment that feels confident enough to reward shareholders at the same time. Dividend growth is rare in this sector, but this is how you can identify a company that will not explode in your face.

The dividend triangle may prevent you from buying Netflix, Tesla, and the like. However, it will also prevent you from buying BlackBerry, Nortel, and Yahoo! at their peak price.

Over the long run, tech stocks are likely going to perform well in a higher interest rate environment since they generate serious cash flow, and they are not typically the most indebted. I've created a small guide to invest in tech stocks later in this newsletter.

The technology sector is best for growth investors but could also offer a haven for income investors.

Target sector weight: growth investors could look at a 10% to 20% exposure to this sector. For income investors, if you have a 5-7% exposure, you'll be well served without significantly affecting your total portfolio yield.

Favorite Picks

U.S.: Microsoft (MSFT), Apple (AAPL), Texas Instruments (TXN), Broadcom (AVGO).

Canada: Constellation Software (CSU.TO), Tecsys (TCS.TO) and Open Text (OTEX.TO / OTEX) to a lesser extent due to lack of growth as of late.

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A SIMPLE GUIDE TO BUYING TECH STOCKS

Tech stocks took a beating in 2022 and prices are now back to more interesting levels. Is the storm over? That's another question. The NASDAQ has outperformed the indexes in 2023. Now for 2024, tech stocks are driven by the rise of artificial intelligence. You can see how fast the narrative changes! It's not even a guarantee that we will have a bullish market in 2024 as many companies saw their PE surged in the past few months.

This guide is first and foremost for investors who have a hard time investing their hard-earned money into the technology sector. For those who are concerned about valuation and fear another tech bubble, I've designed a plan that will only lead to the best of the best. Such companies will likely survive another "tech storm" and most will probably thrive during that storm.

Now, let's establish a few rules to select tech stocks for your portfolio.

Start with the cream of the crop!

Let's start your tech digging project with the dividend triangle. When you pull the stock list in Excel from DSR, use the following filter:

- 5-year revenue growth: positive
- 5-year EPS growth: positive
- 5-year dividend growth: 5%

With this simple filter you will narrow your search down to 22 US companies and 1 Canadian stock. You can also include Constellation Software (CSU.TO) even if it shows negative EPS over the past 5 years. The EPS will quickly go back to positive numbers in the coming quarters.

Yet, analyzing 20+ stocks is a lot. How about we use our DSR ratings? Pick only those with a DSR PRO rating of 4+ and a Dividend Safety Score of 4 and above. This should cut your list of candidates down to 15 stocks (11 US and 0 Canadians!).

At this point, you should be able to read each stock analysis and pick the one you understand the best. Some tech business models are more complex than others. Let's dig into the most common ones.

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Understand the business model

There is nothing better for gaining confidence in a company than understanding what they do. Most people I know thought I was crazy to drive through Central America with my family. I told them it was all about "calculated risks". They feared the unknown while I made sure I understood which kind of adventure I was getting my family into. Would you walk around downtown Chicago at 2am on a Tuesday night? Unless it is your neighborhood and you know everything about each corner, you would most likely not do such a thing. Let me share a few insights about my two favorite tech industries.

Software as a Service (SaaS)

SaaS is pure magic for an investor. Put in simple words, the user pays a subscription to use a piece of software. Think of the bill you pay each year to have Microsoft Windows or Office 365. The difference with SaaS is that all the work is done through a cloud-based system. Microsoft doesn't need to come to your house to update your software and you don't need to buy a CD to install the new version anymore. Everything is done automatically: you pay Microsoft, and they make sure you have access to the most up-to-date version of their software.

The beauty of this business model is that it generates recurring revenues, and it is highly scalable. The nature of SaaS will likely provide steady revenue growth if client retention is good.

Semiconductors

They are also called semis or chips. Semiconductors are materials used in many products to amplify signals, switching, and energy conversion. These companies invest massively in R&D to create smaller, faster, and less expensive chips. When you invest in a dividend grower in this industry, you usually select a company that has gone through many economic cycles. Therefore, semiconductor companies that grow their dividends yearly are companies with a strong expertise and a stable core business.

Semiconductors could be like "industrial" tech companies. Demand for chips is highly cyclical as their customers go through investment cycles where they are looking to improve their own products. In an upcycle, many companies are looking to improve their products. New technology is making the chip smaller, faster, or cheaper and is boosting innovation. Then, once the money has been spent, semiconductor customers promote their new project and cash some profit. They will wait for the next technology breakthrough before making another massive investment.

Following the cyclical nature of semiconductors will lead to potentially great buying opportunities.

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Major themes around the tech industry

Most financial literature on tech stocks will center around a few common themes: Artificial Intelligence (AI), the Internet of Things (IoT), 5G and the Cloud. We have discussed those themes for almost a decade now (except for 5G and AI) and yet, there is probably more than another decade of growth in front of us.

In early 2023 everybody was amazed by ChatGPT, an AI chatbot. You can do a lot of things with artificial intelligence already, and this segment will only continue to grow. However, that's chasing a trend and not an investment strategy. Fortunately, one of the largest players in AI usage (and an investor in ChatGPT) is Microsoft.

The industry has suffered from chip shortages, but we are now back in full growth mode. The rising need of computer power to support AI should drive most semiconductors (and equipment makers) for a while. Therefore, we should see an increase in technology investments in 2024 which should drive sales back to an uptrend.

The key is to pick from among the leaders in those themes. New companies will surf those tailwinds as well. Many will succeed and thrive and many more will crash and burn. At DSR, we are not in the business of investing in those new tech stocks. I'm not saying they are bad investments, but they just don't fit our investment strategy.

To be successful in this sector, you don't need to find the next breakthrough technology. You don't need to be a tech wizard and understand how a 7nm chip will make a difference in your computer.

By using DSR metrics and ratings, we are already doing the screening for you.

I trust this short guide will help you make much better decisions when you evaluate technology stocks.

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>
> *One great part of the DSR service is Mike's inter-activeness with his subscribers. He does this regularly through both newsletters and webinars. His webinars are highly interactive, with subscribers able to make comments and input questions as it goes. Each and every time I have sent a separate email to Mike's service he has personally responded with helpful input. I recommend this service to anyone who is focused on dividend stocks and values a separate analysis of their holdings to help verify their portfolio's value and safety."*

Rick Urquhart, DSR PRO members since September 25th, 2017.

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